Part 7 Business Organizations CHAPTER 21 Forms of Business Organization Page 495 CASE OPENER The Dunkin’ Donuts Franchise Agreement Dunkin’ Donuts Corporation operates numerous restaurants worldwide, organizing many of them as franchises. Dunkin’ Donuts has the exclusive license to use and to license others to use its trademarks, service marks, and trade name. These marks and trade name have been used continuously since 1960 to identify Dunkin’s doughnut shops as well as the doughnuts, pastries, coffee, and other products associated with those shops. Dipak N. Bhayani operated two Dunkin’ Donuts franchises in Illinois for many years. Dunkin’ Donuts later notified Bhayani that his two franchises had been violating parts of the franchise license agreement. After repeated incidents and failure to cure the violations over a substantial period of time, Dunkin’ Donuts (the franchisor) demanded termination of both of Bhayani’s franchises. Did Dunkin’ Donuts lawfully revoke Bhayani’s franchises? What are some potential problems that a franchisor and a franchisee might experience in their relationship? LEARNING OBJECTIVES LO 21-1 Differentiate among the major forms of business organization. LO 21-2 Describe the advantages of each alternative form of business organization. LO 21-3 Explain the special significance of the operating agreement in a limited liability company. LO 21-4 Recognize the differences among the different forms of business organization. LO 21-5 List the specialized forms of business organization. Page 496 E-Commerce and the Law Exploring Forms of Business Organization on the Internet If you are considering starting a business, the Internet can provide much information to help you decide which form of business you should create. For example, at http://smallbusiness.findlaw.com/incorporation-and-legal-structures.html, you can read more about sole proprietorships, partnerships, and corporations. Furthermore, using the Internet, you can learn about the laws that affect the forms of business within your specific state. For example, at Texas Business Forms (http://www.sos.state.tx.us/corp/forms_option.shtml), you can read about and actually retrieve the forms required to create various business types in Texas. Suppose that you get an idea to produce a novel product. You think that production of this new product could lead to enormous profits, but what is the best way to produce this product? Should you produce it yourself by creating your own business? Do you have enough money to create your own business? What are the legal ramifications for you if your business is not successful? What legal responsibilities do you have with respect to your business? Maybe you share your idea for this new product with your best friend, who suggests that the two of you become partners in the production and sale of this product. What are the benefits associated with forming a partnership? What are the disadvantages? Are there other forms of

businesses that you should consider? Deciding what form of business to create is one of the most important decisions a business makes. The extent of liability, as well as the extent of the control the owner will have over the business, depends on the form of the business. However, the business world is not static, and businesses can, and do, change form over time. Accordingly, this chapter is relevant not only to new businesses but also to existing businesses. The first section in this chapter introduces the major types of business organization, describing how these forms are both created and ended. The second section considers several types of business organization that are less well known but important nevertheless.

Major Forms of Business Organization LO 21-1 Differentiate among the major forms of business organization. Sole Proprietorship If you decide to go into business on your own, you are creating a sole proprietorship, a business organization in which you, as the sole proprietor, are in sole control of the management and the profits. Thus, if you wanted to open a lawn-mowing business or a sewing shop, you would likely be creating a sole proprietorship. It is a naturally occurring form of business organization in the sense that if you started doing business without thinking about the form, you would be a sole proprietor. Why might an entrepreneur choose to create a sole proprietorship over other business organizations? First, a sole proprietorship requires very few legal formalities. Thus, one advantage of the sole proprietorship is the ease of creating such a business. Second, a sole proprietor has complete control of the management of the business. Consequently, the sole proprietor has great freedom to hire employees, determine business hours, and expand or change the nature of the business. Finally, the sole proprietor keeps all the profits from the business. These profits are taxed as the personal income of the sole proprietor. However, sole proprietorships have disadvantages too. Suppose you are the sole proprietor of a restaurant in which someone is injured. This customer sues your business. You are personally liable for any losses or any obligations associated with the business. Consequently, if you accrue large debts because of your business, you might have to sell your home to cover those debts. Moreover, because the sole proprietorship is not considered a separate legal entity, you, as the owner and sole proprietor, can be personally sued. Sole proprietorships are terminated, however, when the sole

proprietor dies. Page 497 Not only are you personally liable for any debts of the business, but the funding for your business is limited to your personal funds as well as loans you might be able to obtain. Thus, sole proprietorships often struggle in the initial stages of business because of large start-up costs in relation to the profits they make. Sole proprietorships are by far the most popular form of business organization in the United States. Exhibit 21-1 summarizes their advantages and disadvantages. Exhibit 21-1Advantages and Disadvantages of the Sole Proprietorship ADVANTAGES DISADVANTAGES Creation is easy. Proprietor is in total control of management. Proprietor keeps all profits. Proprietor has personal liability for all losses. Funding is limited to personal funds and loans. An alternative form of business organization that retains many of the advantages of the sole proprietorship but that addresses the funding drawback, in part, is the partnership. Partnership Suppose you and your best friend from college decide to create a business in which you plan to buy and sell used books and DVDs through the Internet. You both agree that you will share control of the Internet business and will split the profits equally. According to the Uniform Partnership Act (UPA), you have created a partnership, a voluntary association between two or more persons who co-own a business for profit. Except in a few cases, a partnership is not considered a separate legal entity and is dissolved when a partner dies. The UPA governs partnerships in most states in the absence of an express agreement and applies even to partnerships that do not formally file for a partnership or hold elections. What are the advantages associated with creating a partnership? First, the creation of a partnership is easy. The partners, each of whom is considered an agent of the partnership, are generally not required to create an official or even written agreement to create the partnership. Second, because the partnership is in most cases not considered a separate legal entity, the income from the business is taxed as individual income for each partner. Because the income is taxed as personal income, the partners can deduct the business losses. Although there are certain advantages to creating a partnership, there are also disadvantages associated with partnerships. Most important, the partners are personally liable for the debts of the partnership. For instance, suppose you are in a partnership with your best friend, who embezzles $50,000 through your partnership. Because of the partnership, you would likely be held personally liable for the debts of the partnership. In other words, you would likely be responsible for the $50,000. Exhibit 21-2 summarizes the advantages and disadvantages of partnerships. Exhibit 21-2Advantages and Disadvantages of Partnerships ADVANTAGES DISADVANTAGES Creation is easy. Income of business is personal income. Business losses can be deducted from taxes.

Each partner has personal liability for all losses, including those of another partner (in most cases). Although it is not listed in Exhibit 21-2, one advantage of a partnership is the ability to choose the people with whom you want to be partners. As the Case Nugget demonstrates, the courts recognize the right to choose one's partners as a basis for partnership law. Page 498 CASE Nugget Do Partners Have a Duty to Remain Partners? Colette Bohatch v. Butler & Binion Supreme Court of Texas 977 S.W.2d 543 Colette Bohatch became an associate in the Washington, D.C., office of Butler & Binion in 1986. John McDonald and Richard Powers, both partners, were the only other attorneys in the office. After Bohatch was made a partner in February 1990, she became concerned that McDonald was overbilling Pennzoil, the main client of the office. Bohatch met with the law firm's managing partner, Louis Paine, to report her concern regarding McDonald's overbilling. In July 1990, McDonald met with Bohatch to report that Pennzoil was dissatisfied with her work. The next day, Bohatch relayed her concern to Paine as well as to two other members of the law firm's management committee. Paine led an investigation of Bohatch's complaint and discussed the billed hours with the in-house counsel at Pennzoil, who concluded that the bills were reasonable. In August 1990, Paine met with Bohatch, telling her that there was no basis for her claims against McDonald and that she should look for work elsewhere. The firm refused Bohatch a year-end partnership distribution for 1990. Finally, in August 1991, Bohatch was given until November to vacate her office. She filed suit in October 1991, and the firm voted to expel her from the partnership three days later. At trial, the jury ruled that the firm breached the partnership agreement and its fiduciary duty and awarded Bohatch $57,000 for past lost wages, $250,000 for past mental anguish, $4,000,000 total in punitive damages (this amount was apportioned against several defendants), and attorney fees. Later, the trial court reduced the punitive damages to around $237,000. The court of appeals ruled that the firm's only duty to Bohatch was to avoid expelling her in bad faith. When the court found no evidence that the firm fired Bohatch for self-gain, it ruled that Bohatch could not recover for breach of fiduciary duty. The case was appealed to the state supreme court. The supreme court ruled that the firm did not owe Bohatch a duty to remain partners. Although Bohatch presented a compelling argument that firms should not be permitted to expel partners who whistle-blow in good faith, the court could not ignore one basis of partnership law: a belief that partners should be allowed to choose their partners. The court found that forcing firms to keep whistle-blowing partners would cause partners to engage in business with people they could no longer trust, thereby undermining the viability of the partnership. Therefore, the

Texas Supreme Court affirmed the ruling of the court of appeals. Duties of Partners to One Another Most of the duties that partners hold to one another involve a duty to be loyal. They include the fiduciary duty to the other partners, the duty of obedience, and the duty of care. Perhaps the most important duty of the partners is their fiduciary duty. They must, in good faith, work for the benefit of the partnership and refrain from taking any kind of action that will undermine the partnership. Consequently, the partners must not engage in any business that competes with the partnership. Partners must disclose any material facts affecting the business. If a partner derives some kind of benefit from the partnership without the consent of the other partners, they must notify the partners of this benefit. The second duty that the partners have to each other is the duty of obedience, to obey the partnership agreement. If they do not obey the agreement, they can be held liable for any losses that the partnership incurs. Page 499 The third duty the partners have is a duty of care to the other partners. Each partner must perform her management functions to the best of their abilities. If a partner makes an honest mistake in fulfilling their responsibilities to the partnership, they will not be held liable for the mistake. Formation of the Partnership Although an explicit written agreement is not required to create a partnership, the partners are advised to create one. The written agreement ensures that the terms of the partnership will be upheld. For example, suppose that you and your partner orally agree that you will receive three-fourths of the profits because you are doing significantly more management tasks. However, when you distribute the funds, your partner sues you because you give them only one-fourth of the profits. Without a written partnership agreement, the courts will have a difficult time ruling in your favor. A written agreement that creates a partnership is called the articles of partnership. What kind of information do the articles of partnership usually include? First, the partners' names, as well as the name of the partnership, should be listed on the document. Second, the agreement should address the duration of the partnership. The agreement could include the date or event on which the partnership agreement would expire. Alternatively, the agreement could specify that the term of the partnership is indefinite. Third, the agreement should state the division of profits and losses. Fourth, the articles of partnership should establish the division of management duties. Fifth, the agreement should state exactly what capital contributions will be made by each partner. Creating articles of partnership can prevent legal problems by explicitly establishing the terms of the partnership agreement. In some cases, parties who are not named in partnership agreements can be considered partners. How? Suppose you create a partnership agreement with

your best friend. When you interact with your first potential customer, you tell this customer that your parents are also partners in this business. On the basis of your parents' participation in the partnership, the customer decides to place an order to purchase certain goods from you. Your parents discover that you have reported that they are your partners, but they do not contact the customer to tell her that they are not your partners. When your business cannot afford to purchase these goods to sell them to the customer, the customer sues you as well as your parents. Because your parents were aware of the misrepresentation but did not correct it, they will be estopped from denying they are your partners. Although they will not be able to claim the rights associated with being a partner (e.g., sharing the profits), in many states they could be held liable for the costs of the damages to the customer. Most states recognize two situations in which a partnership by estoppel exists. First, as in the preceding example, if a third party is aware of a misrepresentation of partnership and consents to the misrepresentation, a partnership by estoppel is present. Second, if a nonpartner has represented themself as a partner, and a third party reasonably relies on this information to their detriment, the nonpartner can be held liable for the third party's damages. Termination of the Partnership Before the termination of any partnership can be considered complete, a partnership must experience what are referred to as the dissolution stage and the winding-up stage. The first of these stages, dissolution, is considered complete when any partner stops fulfilling the role of a partner to the business (by choice or default). Section 29 of UPA defines dissolution as "the change in the relation of the partners caused by any partner's ceasing to be associated with the carrying on, as distinguished from the winding up"—the activity of completing unfinished partnership business, collecting and paying debts, collecting partnership assets, and taking inventory—"of the business." Depending on the reason for the dissolution, the dissolution will be considered rightful or wrongful. Exhibit 21-3 lists reasons that may be given to dissolve a partnership rightfully. Exhibit 21-3Reasons for Rightful Dissolution of a Partnership The term established in the partnership agreement expires. The partnership meets its established objective. A partner withdraws from the partnership at will. A partner withdraws in accordance with the partnership agreement. A partner is expelled from the partnership in accordance with the partnership agreement. A partner dies. A partner is adjudicated bankrupt. The business of the partnership becomes illegal. A partner is adjudicated insane. A partner becomes incapable of performing the duties as established by the partnership agreement. The business of the partnership can be carried on only at a loss of profits. A disagreement between the partners is

such that it undermines the nature of the partnership. Other circumstances of the partnership necessitate the dissolution. Once a partnership is liquidated, the partners begin the process of winding up, the activity of completing unfinished partnership business, collecting and paying debts, collecting partnership assets, and taking inventory. During the winding up, the partners must still fulfill their fiduciary duty to one another, in the sense that they must disclose all information about the partnership assets. However, during the winding-up process, the partners can now engage in business that competes with the partnership business. Page 500 Who can demand that the winding-up process begin? If a partnership has been rightfully dissolved, any partner can demand the winding-up stage to begin. However, if a partner wrongfully dissolves a partnership, that partner has no right to demand a winding up. CASE Nugget When Does a Partnership Dissolve? In re Leah Beth Woskob, Debtor; Alex Woskob; Helen Woskob; the Estate of Victor Woskob v. Leah Beth Woskob, Appellant U.S. Court of Appeals for the Third Circuit 305 F.3d 177 (2002) In 1996, Leah Beth Woskob and Victor Woskob formed a partnership, the Legends Partnership, to construct, own, and operate the Legends, an apartment building. They were married at the time that the partnership was formed; however, they separated and filed for divorce the following year. During the divorce proceedings, Victor prevented Leah from receiving any of the partnership proceeds. Leah was granted a petition for special relief and awarded the exclusive right to manage and derive income from the partnership. Shortly thereafter, Victor filed for bankruptcy. Leah continued to file tax returns on behalf of the partnership, each of which listed Victor as a general partner. When Victor died in a car accident in 1999, Leah gave his estate notice that she was exercising her right to buy out Victor’s interest in the partnership. Victor’s estate sued, claiming that the partnership had been dissolved previously and requesting that someone be appointed to oversee the winding up of the partnership and a full accounting of the company’s assets. When Leah filed for bankruptcy, the suits were moved to the bankruptcy court. The bankruptcy court ruled in favor of Leah, finding that the partnership had dissolved on Victor’s death. Victor’s estate appealed to the district court, which found that the partnership had dissolved two years before Victor’s death, making Leah’s attempt to buy out Victor’s interest untimely. Leah appealed. The task before the appeals court was to determine the timeliness of Leah’s attempt to buy out Victor’s interest in the partnership, which depended entirely on the date of the dissolution of the partnership. The court looked to the Uniform Partnership Act (UPA), which defined the dissolution of a partnership as “the change in the relation of the partners caused by any

partner ceasing to be associated in the carrying on, as distinguished from the winding up, of the business.” Victor’s estate claimed that the dissolution of the partnership occurred at any one of three points, each at least 18 months prior to Victor’s death. First, Victor excluded Leah from the partnership after they separated; second, Leah excluded Victor from the partnership after seeking special relief from the Court of Common Pleas; third, Victor filed for bankruptcy. The appeals court found that the exclusions of Leah and Victor from the partnership were not, in and of themselves, grounds for automatic dissolution of the partnership. Rather, the exclusions could have provided a basis for dissolution, had either Leah or Victor sought judicial decree of the dissolution after the exclusions. In addition, bankruptcy in and of itself is not grounds for automatic dissolution of the partnership. If the nondebtor partner does not consent to continue the partnership with the debtor, bankruptcy may be grounds for dissolution. However, Leah continued to list Victor as a general partner on the tax returns she filed for the partnership, even after he filed for bankruptcy. Thus, the appeals court found that the partnership had not dissolved prior to Victor’s death in 1999 and that Leah’s attempt to buy out Victor’s interest in the partnership was therefore timely. Page 501 Different Types of Partnerships There are several types of partnerships: general partnerships, limited partnerships, and limited liability partnerships. A general partnership consists of an agreement that the partners will divide the profits (usually equally) and management responsibilities and share unlimited personal liability for the partnership’s debts. Thus, in our Internet business example, you and your best friend would form a general partnership by agreeing to share the management responsibilities and profits as well as assuming unlimited personal liability. Now imagine that your parents want to invest in your Internet business. Suppose that they want to share in the profits associated with the business, but they do not want to share in the management responsibilities or assume personal liability for the debts of the partnership. Your parents can join your business as limited partners, and your partnership would become a limited partnership. A limited partnership (LP) is an agreement between at least one general partner and at least one limited partner. The general partners, you and your best friend, assume unlimited personal liability for the debts of the partnership. However, your parents, the limited partners, assume no liability for the partnership beyond the capital they have invested in the business. Moreover, the limited partners do not have any part in the management of the company. However, limited partners pay taxes on their share of the business profit. If a limited partner dies, the limited partnership is usually unaffected. If a general partner dies, however, the limited partnership is usually dissolved. The

limited partnership must meet certain requirements that are not expected of general partnerships. First, the limited partnership must use the word limited in its title. Second, to create a limited partnership, the parties must file a certificate of partnership with a state office. If the certificate of partnership is incorrectly filed, or simply not filed at all, the courts will rule that a general partnership exists. Consequently, all parties will be held personally liable for all the debts of the partnership. Now suppose that you are an attorney and a partner in a law firm with 30 other partners. Suppose further that one of your partners is sued because they were negligent in their duties as an attorney. This partner has unlimited liability because of professional malpractice. But will you and the other partners at the firm be held liable for this partner's malpractice? Page 502 If you and your fellow partners have created a limited liability partnership (LLP), a different form of partnership than the LP, all the partners assume liability for any partner's professional malpractice to the extent of the partnership's assets. In other words, the limited liability partnership is different from other forms of partnership because the partners' liability for professional malpractice is limited to the partnership. If one partner in an LLP is guilty of malpractice, the other partners's personal assets cannot be taken. Therefore, professionals who do business together commonly use the LLP. It is the extra protection awarded partners in an LLP that makes the LLP a separate form of partnership from a limited partnership. Limited partnerships are not the same as limited liability partnerships. BUT WHAT IF? . . . WHAT IF THE FACTS OF THE CASE OPENER WERE DIFFERENT? Let's say that in the Case Opener, two women, Sara and Melissa, owned Dunkin' Donuts as a partnership. Let's say that Melissa was embezzling funds from the business that made the company incur $50,000 in debt. Sara had all of the documentation to prove that Melissa had embezzled the funds from the business, and she wanted only Melissa to be liable for the debt. How would the court decide in this case? Limited liability partnerships are fairly new; in 1991, Texas was the first state to enact a statute permitting the creation of LLPs. Almost all states now have similar statutes. Like the limited partnership, the LLP has several special requirements. First, the business name must include the phrase Limited Liability Partnership or the abbreviation LLP. Second, the parties must file a form with the secretary of the state to create the LLP. The LLP is not considered a separate legal entity. Each partner pays taxes on his or her share of the income of the business. Exhibit 21-4What's the Difference: Types of Partnerships GENERAL PARTNERSHIP LIMITED PARTNERSHIP LIMITED LIABILITY PARTNERSHIP A general partnership consists of an agreement between the partners that profits and management responsibilities will be shared, as will all personal

liability for the partnership’s debts. A limited partnership consists of at least one general partner, and at least one limited partner. In this arrangement, the general partners assumes all liability for the partnership’s debts, while the liability of the limited partner is restricted to their original capital investment. In a limited liability partnership, all partners assume liability for any partner’s professional malpractice to the extent of the partner’s assets. GLOBAL Context Digital Archive Japan/Alamy Stock Photo Limited Liability Partnerships in Japan The limited liability partnership was not introduced in Japan until 2005. Japan’s LLP limits the liability of its members to their capital contribution. Regarding profits, the LLP requires the members to manage the business and negotiate among each other to determine how profits and losses should be distributed among individual members. When establishing the rules of the LLP, Japan requires either the agreement of all members or a majority of at least two-thirds of the members. Japan also established additional limitations and regulations to ensure the preservation of assets of the LLPs. In Japan, the Limited Liability Partnership Law requires members to work to preserve the assets of limited liability partnerships by putting restrictions on which types of capital contribution are permitted and on the distribution of partnership assets. Page 503 Corporation When you hear the word business, you probably think about businesses such as Walmart, Kmart, McDonald’s, and Nike. Perhaps the most dominant form of business organization is the corporation, a legal entity formed by issuing stock to investors, who are the owners of the corporation. The investor-owners are called shareholders. These shareholders elect a board of directors, which is responsible for managing the business. The board of directors, in turn, hires officers to run the day-to-day business. The corporation is considered a separate legal entity; thus, the corporation can be sued. None of the other forms of business we have discussed are considered separate legal entities. How does a corporation become a separate legal entity? It must be created according to state law. What are the consequences of a corporation’s status as a separate legal entity? First, although the corporation can be held liable, shareholders cannot be held personally liable for the debts of the corporation. Their liability is usually limited to the amount they have invested. Second, the corporation is not dissolved when the shareholders die. Third, the corporation must pay taxes on its profits. In addition, the shareholders must pay taxes on the dividends they receive from the corporation. One way that a corporation can avoid this double taxation is by forming an S corporation, a business organization formed under federal tax law that is considered a corporation yet is taxed like a partnership as long as it follows certain regulations. For example, the S corporation cannot have

more than 100 shareholders. Any income of the corporation is taxed when it is distributed to the shareholders, who must report the income on their personal income tax forms. S corporations are always formed under federal law. S corporations cannot be formed under state law, whereas other forms of corporations are created under state law. Exhibit 21-5 summarizes the advantages and disadvantages of the corporate form of business. Exhibit 21-5Advantages and Disadvantages of Corporations ADVANTAGES DISADVANTAGES Shareholders have limited liability. Issuing stock makes raising capital easy. Profits are taxed as income to the shareholders, not the partners. Corporate income is taxed twice. Formalities are required in establishing and maintaining corporate form. Limited Liability Company One of the newest forms of business organization in the United States is the limited liability company (LLC), an unincorporated form of business organization that many people see as combining the most advantageous features of partnerships and corporations. It combines the tax advantages and management flexibility of a partnership with the limited liability of a corporation. This form of business organization was first recognized in the United States in 1977 in Wyoming and is now recognized in every state, although the rules regarding this new form did not evolve uniformly. As with other areas of law, the National Conference of Commissioners on Uniform State Laws recognized the desirability of bringing some uniformity to this area of law and drafted the Uniform Limited Liability Company Act (ULLCA) in 1995. In 2006, the commissioners revised the ULLCA. This act provides a model for states to follow, but it has not been uniformly adopted, so it is always necessary when establishing an LLC to check the exact requirement of the law for LLCs in the state in which you wish to create your company. LO 21-2 Describe the advantages of each alternative form of business organization. Page 504 Key Reasons for the Rapid Acceptance of LLCs As previously mentioned, the LLC form offers its members the same limited liability for business debts as that offered by the corporate form. However, unlike the corporate form, it does not require profits and losses to be allocated in proportion to ownership interests. Also unlike corporations, LLCs are not required to hold an annual meeting and draft meeting minutes, so record keeping is simpler and more flexible. Unlike the case in limited partnerships, to obtain limited liability, the owner (referred to as a member) does not have to give up his or her right to participate in management of the LLC. In fact, an additional advantage of the LLC form is the flexibility it offers members in terms of alternative ways to structure its management. Because the LLC essentially provides the best parts of other forms of business organization, it has become a very popular method of doing business and

has become the most common choice of organization for new small businesses. The most frequently cited advantage of the LLC is that the IRS generally treats it like a partnership or sole proprietorship, with members reporting their share of the profits and losses of the LLC on their personal tax returns, and no separate tax is assessed on the company itself, thereby allowing its members to avoid the double taxation that owners of a corporation pay. However, if an LLC's members prefer, they may elect to have the entity taxed like a corporation. In a situation in which most of the profits will be reinvested in the business, this option allows the profits to be taxed at the lower corporate rate. So, although we think of the opportunity to avoid double taxation as a key benefit of the LLC, more important, perhaps, is the fact that the members have the choice of how they want to be taxed. In our global environment, an increasingly important advantage of LLCs is that members need not be citizens or permanent residents of the United States. Other organizational forms, such as the subchapter S corporation, are available only when all the owners are U.S. citizens. Finally, as with a corporation, ordinary business expenses, such as salaries paid to owners, can be deducted from the profits of an LLC before the LLC's income is allocated to its owners for tax purposes. LO 21-3 Explain the special significance of the operating agreement in a limited liability company. Formation and Management of LLCs A limited liability company is formed by filing articles of organization in the state in which members want to establish their LLC. Although precise requirements vary by state, typically the articles include the name of the business, which must include the words Limited Liability Company or the initials LLC, its principal business address, the name and address of a registered agent for service, the names of the owners, and information about how the company's management will be structured. LLCs typically want to do business in states other than the state in which they are formed, and they usually need to register in every additional state in which they want to operate, a process typically referred to as qualification. Qualification simply entails filing a certificate of authority or a similar document and getting a business license in each additional state in which the business plans to operate. The LLC will usually be referred to as a foreign company in the additional states, and, under most state statutes, the LLC will be governed by the LLC rules of the state in which it was created, regardless of where it is transacting business. For purposes of jurisdiction, however, an LLC is considered a citizen of every state in which its members reside. Remember that a party can be sued in federal court over a matter involving more than $75,000 when diversity of citizenship exists, that is, when no plaintiff and defendant are residents of the same state. For determining

whether diversity exists, a corporation is considered a resident of both the state in which it is incorporated and the state in which it has its primary place of business. However, this rule does not apply to LLCs because their citizenship is determined by the residences of their members. Consequently, if parties want the flexibility to avail themselves of the federal courts, they may want to limit their membership to individuals of only one or a few states or use a different form of business organization. Page 505 When members form an LLC, they typically draft an operating agreement, which is the foundational contract among the entity's owners. It spells out such matters as how the company is to be managed, how the profits and losses will be allocated, how interests may be transferred, and how and when the LLC may be dissolved. Any matter not covered in the operating agreement will be resolved in accordance with the state LLC statute; if a matter is not covered by the relevant statute, the principles of partnership law are generally followed. Although an LLC is not required to have a detailed, written operating agreement, to ensure the smooth functioning of the company, it is a good idea to have such an agreement. Failure to have a detailed, written agreement may result in a court imposing standards on the company that may be very different from what the members had in mind when forming the company. It is very important, however, to make sure that everyone understands the terms of the operating agreement, because once the parties enter into such an agreement, the courts will enforce it. One of the key issues to be determined in the operating agreement is how the company is to be managed. There are two options: member-managed and manager-managed. Under the ULLCA, unless the operating agreement specifies otherwise, LCCs are member-managed. In a member-managed LLC, all members participate in management, with decisions in the ordinary course of business activities made by a majority vote. The consent of all members, however, is required to sell, lease, exchange, or otherwise dispose of all, or substantially all, of the company's property; approve a merger or conversion to a different form; undertake any other act outside the ordinary course of the company's activities; and amend the operating agreement. The members in such an LLC all have the apparent and actual authority to enter into contracts on behalf of the LLC. In a manager-managed LLC, the members select a group of managers to manage the affairs of the company. The managers may be selected from the members or may be nonmembers. The managers have the apparent and actual authority to enter into contracts on behalf of the LLC, whereas the members who are not managers do not have such authority. The managers owe the LLC and its members the same fiduciary duties as the officers and directors of a corporation owe to the

corporation and its shareholders. BUT WHAT IF? . . . WHAT IF THE FACTS OF THE CASE OPENER WERE DIFFERENT? Let’s say in the Case Opener that two doughnut shops, Dunkin’ Donuts and Harry’s Bagels, joined to produce one kind of doughnut that turned out to be a big hit. The two companies decided to form a partnership in producing this doughnut together. What kind of company would this be called? LO 21-4 Recognize the differences among the different forms of business organization. Exhibit 21-6 provides a comparison of the alternative forms of business organization. Exhibit 21-6Comparison of Alternative Forms of Business Organization SOLE PROPRIETORSHIP GENERAL PARTNERSHIP LIMITED PARTNERSHIP CORPORATION LIMITED LIABILITY COMPANY Legal Position Not a separate legal entity. Not a separate legal entity in most states. A separate legal entity. A separate legal entity. A separate legal entity for purposes of liability but not always for taxes. Control Considerations Sole proprietor has total control. Each partner is entitled to equal control. Each partner is entitled to equal control. Separation of ownership and control. Members control allocation of control. Liability Sole proprietor has unlimited personal liability. Each partner has unlimited personal liability for partnership debts. Each partner has liability limited up to his or her capital contribution. Liability is limited to loss of capital contribution. Liability is limited to loss of capital contribution. Lifetime Limited to life of proprietor. Limited by life of partners. Limited to life of general partners. Can have unlimited life. Operating agreement spells out the lifetime. Taxation Profits are taxed directly as income to the sole proprietor. Profits are taxed as income for partners. Profits are taxed as income for partners. Profits are taxed as income to corporation and as income to partners in the form of dividends. Operating agreement spells out whether profits will be taxed as a corporation or partnership. Transferability of Ownership Interest Nontransferable. Nontransferable. Nontransferable. Generally unlimited transfer. Operating agreement spells out the transferability. Dissolution of LLCs Under the ULLCA, an LLC dissolves on the happening of any event that the operating agreement specifies will cause dissolution, the consent of all the members, the passage of 90 consecutive days during which the company has no members, or the issuance of a court order for dissolution. Under the ULLCA and most state LLC statutes, a member’s voluntary withdrawal from the LLC, referred to as dissociation, does not terminate the LLC. The following Global Context is especially valuable as a comparator with business forms in the United States because Croatia has such an extensive variety of options. Page 506 GLOBAL Context Digital Archive Japan/Alamy Stock Photo Business Entities in Croatia Croatia has a vast variety of busi-ness organizations. Many of these organizations

have equivalents in U.S. law: for example, the d.d. (public corporation), j.t.d. (general partnership) and d.o.o (LLC). An interesting aspect of the Croatian d.o.o is that it must have a minimum capital of 20,000 kuna, or about $3,000. Croatia has a separate entity type, the j.d.o.o., for companies with less than 20,000 kuna in capital; these entities must set aside 25 percent of their annual profit until they have enough equity capital to become a d.o.o. But where Croatian business entities really diverge from the U.S. is in sole proprietorships, or obrts. Croatia has seven different types of obrts. First is the slobodni obrt (free propri-etorship) which is the standard sole proprietorship. Others are the vezani obrt (tied proprietorship) and povlašteni obrt (privileged proprietorship), which are reserved for master craftsmen. Next are the paušalni obrt (flat-rate proprietor-ship) and obrt-dohodaš (income tax proprietorship), and obrt-dobitaš (profits tax proprietorship), which each grant different tax benefits. Finally, there is the sezonski obrt (sea-sonal proprietorship) which runs for a limited number of months during the year. In addition to the obrts, there is the slobodna djelatnost (free profession) reserved for certain types of professions (e.g. artists, journalists, and lawyers), the domaća radinost (home business) for home businesses providing supplementary income, and the OPG for family-run agricultural businesses.

Specialized Forms of Business Organization LO 21-5 List the specialized forms of business organization. In addition to the more traditional forms of business organization mentioned, the following specialized forms of business organization have become increasingly important: cooperatives, joint stock companies, business trusts, syndicates, joint ventures, and franchises. Cooperative A cooperative is an organization formed by individuals to market products. The cooperative is a business organization in which the members usually pool their resources to gain some kind of advantage in the market. For instance, farmers might pool certain crops to ensure that they get a high market price for their crops. Usually, members of the cooperative receive dividends in proportion to how many times a year they engage in business with the cooperative. Cooperatives may be incorporated or unincorporated. Unincorporated cooperatives are treated like partnerships, meaning that the members share joint liability for the cooperative’s actions. Members of incorporated cooperatives, on the other hand, enjoy limited liability just as do the shareholders of a corporation. Joint Stock Company A joint stock

company is a partnership agreement in which company members hold transferable shares whereas all the goods of the company are held in the names of the partners. Thus, the joint stock company is a mixture of a corporation and a partnership. As with the corporation, the members who hold shares of stock own the joint stock company. As with the partnership, the shareholders have personal liability, and in most cases, the company is not a separate legal entity. The joint stock company is formed by agreement rather than by statute. Business Trust A business trust is a business organization governed by a group of trustees, who operate the trust for the beneficiaries. A written trust agreement establishes the duties and powers of the trustees and the interests of the beneficiaries. As with a corporation, the trustees and beneficiaries enjoy limited liability, and, in most states, business trusts are taxed like corporations. Syndicate An investment group that comes together for the explicit purpose of financing a specific large project is a syndicate. Syndicates are often used in the purchase of professional sports teams. The syndicate is quite useful in the sense that it can raise large amounts of money in a small amount of time. Syndicates are usually considered a type of joint venture; thus, they are almost always governed by partnership law. Joint Venture A joint venture is a relationship between two or more persons or corporations created for a specific business undertaking. This relationship may entail financing, producing, and selling goods, securities, and commodities. Participants in the joint venture usually share the profits and losses of the joint venture equally. Page 508 Joint ventures can be agreements between small businesses as well as agreements between very large businesses. For example, Nestlé and Häagen-Dazs entered into a joint venture to create Ice Cream Partners, USA. Generally, joint ventures are taxed like partnerships. In fact, from a legal standpoint, partnerships and joint ventures are virtually the same. Thus, courts frequently apply partnership law to joint ventures. Joint ventures differ from partnerships, however, because a joint venture is usually created for making and selling a single product, whereas a partnership creates an ongoing full business. Once all the single products are sold, the joint venture is usually terminated. The members, however, can determine when the joint venture will end. Despite the similarities, there are several minor differences between partnerships and joint ventures in the eyes of the law. First, if one of the members of a joint venture dies, the joint venture is not automatically terminated. Second, the members of a joint venture have less authority than general partners because members of a joint venture are not agents of the other members. The parties who comprise a joint venture usually share equal management of the task for which they have come together. They, however,

can make an agreement to give one party greater management responsibilities. Furthermore, all the parties usually assume liability for the project. Each party can be held responsible for the liability of another party in the joint venture. Case 21-1 presents a discussion of a key necessary component of the establishment of a joint venture. CASE 21-1 TAXINET, CORP. v. LEON No. 16-23266 (S.D. Fl. 2020) FACTS: This case arises from a failed joint venture to providea mobile taxi hailing service in Mexico City. Plaintiff, Taxinet, Corp., is claiming that it entered into a joint venture with Defendant Santiago Leon to obtain a concession agreement with Mexico City, and Leon cut Taxinet out of the deal. Mexico City awarded Leon a concession agreement to operate the service for ten years. Plaintiff seeks damages incurred asa result of its lost opportunity to operate the concession agreement in Mexico City. Leon moves for summary judgment on the affirmative defense that the Statute of Frauds bars Taxinet's claims. He argues the parties' oral joint venture agreement was to operate a mobile taxi hailing service in Mexico City, which could not be performed within a year and thus, any claims arising from that agreement are barred by the Statute of Frauds. Taxinet argues that the joint venture was formed for the sole purpose of obtaining the concession agreement, which can (and was) completed in under a year. Taxinet relies on the parties' text messages and emails, two of which bear Leon's electronic signature, as evidence of the joint venture agreement. ISSUE: Had a joint venture truly been formed between the parties? REASONING: A signed writing overcomes the Statute of Frauds defense. The Magistrate Judge concluded that there was no signed writing establishing a meeting of the minds on the essential terms of a joint venture in this case. The parties agree the material terms of a joint venture are (1) community of interest in the performance of the common purpose; (2) joint control or right to control; (3) a joint proprietary interest in the subject matter; (4) a right to share in the profits; and (5) a duty to share in any of the losses, which may be sustained. In late October 24, 2015, Leon sent the first signed email where he complains about technical software issues and proposes a revised equity split to reduce Taxinet's interest. In that email, he refers to his "future partners" and signs it with a "hope you can agree." Leon's second email days later again changes the equity split, but changes Pedro Domit's interest. Tellingly, that email states that they had a meeting where the "aim was to be clear about what we believe would be a fair plan in the different possible scenarios. . . I have agreed to add my basic observations in order to establish a common starting point for the successful and correct implementation on the project. . . I think that today we set out the necessary foundations to speak openly about our interests, which must

work for the common good of all parties in the end.” Taxinet views this email as a proposed amendment to the prior agreement, which is not evidenced in an executed writing. The parties had previously exchanged text messages on the equity split. Similarly, the emails from Domit summarize discussions about the proposed by-laws and articles of incorporation, but he asks Leon and Noboa “if anything is wrong, or missing, add it.” Whether they agreed or not is not in the record. Moreover, the terms themselves contemplate future agreement, as he stated in the email: ”the consolidation process of the operation with Taxinet Corp. will be documented in an agreement between Taxinet Corp. and the partners of the Mexican company.” The Magistrate Judge correctly concluded that Leon’s stand-alone emails cannot evidence a meeting of the minds. Even if the Court views his signed emails together with the text messages, they do not show a meeting of the minds as to the equity split, but rather, as the Magistrate Judge concluded “memorialize a number of different agreements reached on this term.” The emails are replete with language contemplating a future agreement. Domit’s email similarly states it is a summary of his understanding of the discussions and requests input from the partners. Accordingly, the Court agrees with the Report’s recommendation that the writings do not establish a meeting of the minds showing agreement on the material terms. DECISION AND REMEDY: Defendant’s motion for Summary Judgment GRANTED. SIGNIFICANCE OF THE CASE: This case lays out the elements of a joint venture and how a court differentiates between an actual joint venture and an intended joint venture. CRITICAL THINKING Notice the importance of a single fact. What is the impact of the existence of emails contemplating a future agreement? ETHICAL DECISION MAKING Explain the Court’s decision using the language of the ethical guidelines in the WH format of ethical reasoning. Page 509 Franchise When you go into McDonald’s to eat lunch, what type of business are you patronizing? You are likely eating at a franchise, a business that exists because of an arrangement between the franchisor, an owner of a trade name or trademark, and the franchisee, a person who sells goods or services under the trade name or trademark. What are the advantages and disadvantages for the franchisor and the franchisee? Exhibits 21-7 and 21-8 summarize these advantages and disadvantages. First, the franchisee enjoys the franchisor’s help in opening the franchise. Second, think about how many times you have driven through a strange town and felt relieved when you saw a Burger King. Even though you may have never been to that town before and did not know who controlled that particular business, you know Burger King. Before you walk into the restaurant, you know almost exactly what will be on the menu. Thus, on the one hand, the franchisee benefits

from the franchisor’s strong trade name or trademark. Moreover, the franchisee benefits from the franchisor’s worldwide advertising of the trade name or trademark. The franchisor, on the other hand, does not take a large risk in creating the franchise, yet it can greatly benefit from the income it receives from the franchisee. Exhibit 21-7Advantages and Disadvantages to the Franchisee of Starting a Franchise ADVANTAGES DISADVANTAGES Help from the franchisor in starting the franchise. Instant recognition due to the franchisor’s strong trademark or trade name. Benefits from the franchisor’s worldwide advertising. Must meet the franchisor’s standards or risk losing the franchise. Has little to no creative control over the business. Exhibit 21-8Advantages and Disadvantages to the Franchisor of Starting a Franchise ADVANTAGES DISADVANTAGES Low risk in starting a franchise. Increased income from franchises. Has little control over the franchise. Can become liable for the franchise if it exerts too much control. Page 510 Generally, franchises fall into one of three categories. McDonald’s and Burger King are examples of chain-style business operations. In a chain-style business operation, the franchise operates under the franchisor’s business name and is required to follow the franchisor’s standards and methods of business operation. The second category of franchises is the distributorship. Distributorships are franchises in which the franchisor manufactures a product and licenses a dealer to sell the product in an exclusive territory. A car dealership is an example of a distributorship. Finally, the third category of franchises is the manufacturing arrangement. In a manufacturing arrangement, the franchisor provides the franchisee with a formula or necessary ingredient to manufacture a product. The franchisee then manufactures the product and sells it according to the franchisor’s standards. It should be noted that a franchise is not a legal entity itself by default. For example, a franchisee can choose to incorporate their franchise or register their franchise as an LLC while operating under a franchise agreement. Exhibit 21-9 describes the various types of franchises. Exhibit 21-10 provides a sense of just how important franchises are for the market economy. Exhibit 21-9Types of Franchises FRANCHISE TYPE DESCRIPTION Chain-style business operation Franchisor helps franchisee set up a business run under the franchisor’s business name according to the franchisor’s usual methods and standards. Distributorship Franchisor licenses franchisee to sell the franchisor’s product in a specific area. Manufacturing arrangement Franchisor provides the franchisee with the technical knowledge needed to manufacture the franchisor’s product. Exhibit 21-10The Top 10 Global Franchises, 2018 McDonalds 7-Eleven Inc. Dunkin’ Doughnuts The UPS Store RE/MAX Sonic Drive-In Great Clips Taco Bell Hardee’s Sport Clips Source:

Ranked by Entrepreneur Magazine on the basis of financial strength and stability, growth rate, and size of the system; www.entrepreneur.com/franchise500/index.html. Franchise Law Because franchisors are usually larger than franchisees and have more resources, they often have the upper hand in franchise relationships. Federal and state laws, however, have been established to protect the franchisee in the franchise relationship. In addition, several laws that are more specific have been established to govern the franchise relationship. For example, the Federal Trade Commission has a franchise rule requiring franchisors to present prospective franchisees with the material facts necessary for the franchisee to make an informed decision about entering a franchise relationship. Moreover, the Automobile Dealers' Franchise Act of 1965 prohibits car dealership franchisors from terminating franchise relationships in bad faith. Thus, for example, DaimlerChrysler could not terminate its franchise relationship with a dealer because the dealer failed to meet impossible standards. Finally, the Petroleum Marketing Practices Act of 1979 outlines the reasons for which a franchisor may terminate a gas station franchise. Franchises must also be aware of federal antitrust laws. Antitrust laws prohibit specific forms of anticompetitive behavior and might be applicable to franchises. Page 511 Case 21-2 spells out the criteria courts use to determine whether a business is a franchise. CASE 21-2 LIVE CRYO, LLC v. CRYOUSA IMPORT AND SALES, LLC United States District Court, E.d. Michigan, Southern Division (2017) FACTS: CryoUSA Import and Sales, CryoUSA Franchising, LLC, CryoUSA Holding, LLC, and CryoUSA Mobile, LLC are Texas corporations. Together, they obtain, supply, and provide training to operate cryotherapy chambers. Cryotherapy chambers use liquid nitrogen to maintain a temperature of 240 degrees below zero. Clients enter the cryotherapy chamber to allegedly gain health benefits such as more restful sleep, improved mood, and better athletic performance. Live Cryo, LLC, is a Michigan corporation that entered an agreement with the CryoUSA corporations on July 15, 2016. The agreement provided that Live Cryo could exclusively distribute cryotherapy chambers in Michigan for a 24-month period. The agreement also provided that Live Cryo had to purchase 15 chambers within the first six months to maintain the exclusive dealership status. In addition, CryoUSA was to control all marketing and training, with all cryotherapy chambers bearing its mark. Relevant to this case, the agreement also contained a choice-of-law provision that called for the application of Texas law in any legal dispute. Live Cryo found that the cryotherapy chambers did not work as described. For example, an HVAC technician hired to examine the chambers concluded that it never reached

166 degrees below zero. Experiencing various difficulties, Live Cryo sued the CryoUSA corporations, alleging the defendants had engaged in fraud and were in violation of the Michigan Franchise Investment Law (MFIL). In its defense, CryoUSA argued that Texas law should apply because of the choice-of-law provision in the agreement. Live Cryo contended that MFIL made void the choice-of-law provision. In response, CryoUSA argued that MFIL did not apply because Live Cryo was not a franchisee. ISSUE: Is Live Cryo a franchise of CryoUSA? REASONING: Under Michigan law, there are three factors which determine whether a business is a franchise: (a) the franchisee sells or distributes goods under a marketing plan or system prescribed by the franchisor; (b) the franchisee is granted the right to sell or distribute goods or services associated with the franchisor's trademark, logo, advertising, or other commercial symbol; (c) the franchisee is required to pay, directly or indirectly, a franchise fee. The court found that the first criterion was met. The agreement between the two parties stated that "[Live Cryo] shall be allowed to further the promotion, marketing, sale and other distribution of the Products in the Territory and to keep CryoUSA informed of marketing developments." The court also determined that the second criterion was met as all products sold by Live Cryo bore the CryoUSA name and logo. Live Cryo was also specifically allowed to use CryoUSA marks, including "Cryosense" and "CryoUSA ETablet." Finally, Live Cryo argued that it paid an indirect franchise fee because CryoUSA charged a "mark up" on the purchase of each chamber as well as a $10,000 fee to renew the agreement. Because Live Cryo had to pay this fee to do business with (and, arguably, on behalf of) CryoUSA, the court found the third criterion to be satisfied. With these facts in mind, the court found that there was a question of fact as to whether the parties entered into a franchise agreement. As such, the court would not enforce the forum selection clause in the agreement and allowed Live Cryo to proceed with its claims. DECISION AND REMEDY: In favor of Live Cryo. SIGNIFICANCE OF THE CASE: This case delineates some of the common criteria for determining whether a business is a franchise or not. It also explores a legal implication of that distinction, i.e., whether a choice of law clause is valid based on the distinction. CRITICAL THINKING What facts would have had to have been different for the court to have ruled that there was no franchise agreement in this case? ETHICAL DECISION MAKING What stakeholders would benefit from laws that made it more difficult for a business to be a franchise? Page 512 Creation of the Franchise In the franchise relationship, the parties make a franchise agreement regarding various factors: the payment to the franchisor, the location of the franchise, the restrictions the franchisee must follow, and the method of termination of

the franchise. First, the franchise agreement usually states that the franchisee is to pay a large sum to the franchisor for use of the trade name or trademark. Moreover, the agreement determines what percentage of the income from the sales of the goods will go to the franchisor. Second, the agreement usually determines where the franchise will be located. If the franchise requires a building, the agreement specifies who will pay for buying or renting the building. Similarly, if the building must be constructed, the agreement states who is responsible for the costs of the construction of the building. Third, the franchisor usually includes in the agreement certain business practices that are forbidden and other business standards that must be met. For example, the franchisor might require the business to meet specific levels of cleanliness. Moreover, the franchisor can set certain sales quotas as well as requirements for record keeping by the franchisee. The franchisor can require the franchisee to purchase certain supplies from the franchisor at a set price, but the franchisor cannot attempt to establish the price at which the franchisee must sell the goods. The disagreement in the opening scenario for this chapter arose because of the third factor in franchise agreements. Because many Dunkin' Donuts restaurants are owned by franchisees, Dunkin' Donuts established guidelines and policies that promote business practices that enhance the quality of food and services at each restaurant. Dunkin' Donuts also has quality, safety, and cleanliness standards for each of its franchises. The franchise agreement stipulated that Dunkin' Donuts could inspect Bhayani's restaurant at any reasonable time. Although the franchisor has the legal authority to ensure that the franchisee maintains the quality of goods and services associated with the franchise, the franchisor must be cautious. If it exercises too much authority in the day-to-day affairs of the business, the franchisor could be held liable for the torts of the franchisee's employees. Termination of the Franchise The franchise agreement establishes how the franchise will be terminated. The franchise is usually established for a trial period, such as a year. If the franchisee does not meet the requirements established in the franchise agreement, the franchisor can terminate the franchise agreement, but the franchisor must give the franchisee sufficient notice of the termination. Furthermore, the termination usually must have cause. Much of the litigation associated with franchises regards wrongful termination of a franchise. The typical agreement gives the franchisor broad authority to terminate a franchise. In recent years, however, many states have been giving the franchisee greater termination protection. The courts usually rely heavily on the written franchise agreement when determining whether a franchise was wrongfully terminated. Look at Case 21-3, which illustrates the importance of the

written franchise agreement. CASE 21-3 COUSINS SUBS SYSTEMS, INC. v. MICHAEL R. MCKINNEY U.S. District Court for the Eastern District of Wisconsin 59 F. Supp. 2d 816 (1999) FACTS: Cousins Subs Systems entered into an agreement with Michael McKinney, a Minnesota businessman who owned a company that operated a chain of gas stations, for McKinney to operate several Cousins submarine sandwich shops. The sub shops were to be placed in the gas stations. In April 1998, McKinney became disillusioned with the agreement and terminated the agreement. McKinney claimed that Cousins guaranteed him annual sales at each of his franchises ranging from $250,000 to $500,000. Furthermore, McKinney argued that Cousins promised to provide advertising for the franchises. McKinney also claimed that Cousins guaranteed it would provide assistance in recruiting other franchises. McKinney alleges that he terminated the agreement because Cousins failed to uphold these promises. In June 1998, Cousins filed suit against McKinney for wrongfully terminating the agreement with Cousins. Later in 1998, McKinney filed a counterclaim against Cousins. Cousins filed a motion to dismiss the counterclaim. ISSUE: Did Cousins Subs Systems make misleading statements of material facts? REASONING: McKinney alleges that Cousins violated the Minnesota statute prohibiting businesses from using false statements of material facts (or omissions of material facts) to sell franchises. McKinney claims that Cousins made false verbal statements of material facts; however, when an alleged verbal statement contradicts a written contract, the written contract carries more weight. In this case, the written contracts, signed by McKinney and Cousins and later entered as exhibits, contradict the verbal statements McKinney claims Cousins made. The contracts state that no promises were made regarding the profit McKinney would earn, that advertising was McKinney’s responsibility, and that the contracts contained all terms, conditions, and promises made by Cousins. DECISION AND REMEDY: As demonstrated by the contracts McKinney signed, Cousins did not make any misleading statements of material facts. The counterclaim was dismissed. SIGNIFICANCE: It is unclear whether Cousins made the verbal promises alleged by McKinney. Regardless, McKinney did sign contracts that contradicted the alleged verbal promises. This case demonstrates how important it is for businesspeople to read contracts thoroughly and to ensure that all terms, conditions, and promises are contained in those contracts. CRITICAL THINKING What are the primary facts of this case? How would you word the issue of the case in your own words? The judge stated that the written terms of the contracts between Cousins and McKinney were inconsistent with any alleged oral agreements that they made. Do you agree that written contracts should overrule oral

agreements in most instances? Why or why not? ETHICAL DECISION MAKING The court ruled in favor of Cousins. Who are the primary stakeholders affected by the court's ruling for Cousins? Page 513 CASE OPENER WRAP-UP Bhayani's Dunkin' Donuts franchises violated the license agreement on multiple levels. Financially, under the franchise agreements, Bhayani agreed to pay a franchise fee of 4.9 percent of gross sales to Dunkin' Donuts and an advertising fee of 5 percent of gross sales to the Franchise Owners Advertising and Sales promotion fund. However, Bhayani fell behind on both financial payments on numerous occasions. By the time Dunkin' Donuts sent notice of termination, Bhayani owed $33,189.38 in delinquent fees and failed to cure the financial default. Furthermore, Bhayani's franchises were also in violation of health and safety standards from the license agreement. During its routine health inspections, Dunkin' Donuts found multiple health and sanitation violations such as pests and evidence of pests; improper storage, refrigeration, and cooking temperatures; improper food and chemical storage; unsanitized utensils; faulty faucets; unclean floors, walls, countertops, toilets, and sinks; insufficient employee hygiene; ill-kept trash areas; and various documentation deficiencies. While some of these were cured by the time of the next inspection, most were not. After each substandard inspection, Dunkin' Donuts sent a notice of default and notice to cure. On the basis of the perceived failure to cure these violations over a substantial period of time, Dunkin' Donuts sent Bhayani a supplemental notice of termination. As a franchisor, Dunkin' Donuts Corporation is permitted to establish certain standards for franchisees. With regard to Bhayani's restaurants, Dunkin' Donuts established standards for cleanliness and also negotiated financial rates. In accordance with the provisions in the license agreement, Dunkin' Donuts terminated the franchises. Bhayani claimed that any breaches of the agreement by him—either financial breaches or health, sanitation, and safety violations—were directly caused by the bad-faith actions of Dunkin' Donuts. He argued that Dunkin' Donuts targeted him for his franchisee activism by classifying him as a "C" franchise and blocking his attempt to open another franchise. However, the court found that Bhayani did not show that his franchises were exceptional or that they were terminated on the basis of some sort of "pretext" of Dunkin' Donuts. Thus, Dunkin' Donuts was well within its legal rights to terminate the franchise agreement. Disagreements regarding payments or health standards of franchises are examples of what could go wrong with a franchising agreement. Another example of potential problems between franchisors and franchisees is disagreement over the termination of the franchise. All of these problems existed in the Dunkin' Donuts case. Both

parties probably would have benefited from a greater understanding of the responsibilities of the franchisor and franchisee. Page 514 PRACTICAL TIPS for Business Managers As this chapter demonstrates, there are many, many ways to organize your business, each with its distinct advantages and disadvantages. Before starting a business, take ample time to think about what type of business model will best suit your needs. Consider questions such as, what type of product or service do I want to provide? Should I operate this business on my own, or do I need help running it? Will I need to raise funds or capital at some point in my business's life? Do I intend to manage this business for a long time? Thinking about these and other factors can help you decide how best to form your business. Although there are statutes that cover all forms of doing business, each type of business organization has its own set of rules and regulations as well. For example, the laws surrounding partnerships are different from the ones concerning corporations. Be sure to know the law surrounding your particular type of business and do not assume that just because an LLC can do action X means that your franchise or joint venture can also do X. The cases in this chapter should indicate to you that franchises, while beneficial in many ways, come with their own complex legal disputes concerning employees and agreements. If you decide to start a franchise, do your best to keep communication open between yourself, your franchisor, and your employees so that each party knows its duties and rights under the franchise agreement.

SUMMARY Major Forms of Business Organization Sole proprietorship: The owner has total control and unlimited personal liability, and profits are taxed directly as income to the sole proprietor. General partnership: For most purposes, the partnership is not a legal entity, and each partner has equal control and unlimited liability, with profits that are taxed as income for partners. Limited partnership: Limited partnerships are similar to general partnerships, except that limited partners' liability is limited to the extent of their capital contributions. Corporation: A corporation is a separate legal entity wherein the owners' liability is limited to the amount of their contributions, and the profits are taxed as income to the corporation. Limited liability company: A limited liability company combines the best tax and liability features of partnerships and corporations. In an LLC, all members may participate in management of the business entity while enjoying a shield of limited liability for their personal assets. Specialized Forms of Business Organization The specialized forms are cooperatives, joint stock

companies, syndicates, business trusts, joint ventures, and franchises. A franchise is a contractual relationship between the franchisor and the franchisee. Thus, contract law, and the Uniform Commercial Code in particular, applies to the franchise relationship. If the terms of the contract are not met, either side can sue for breach of contract.

Point/Counterpoint Should Aspiring Business Owners Form an LLC Instead of a Corporation? YES NO While traditional corporations certainly have their benefits, LLCs present a hybrid form of business that combines that best parts of corporations and partnerships. There are several reasons to form an LLC instead of a corporation. First, forming and running an LLC can be much easier than doing so for a corporation. LLCs require much less paperwork and registration to form, and LLCs can deduct business losses–such as those incurred while starting the business–on their personal tax returns. Corporations are also required to have a board of directors that oversee business decisions and are required to hold meetings and publish annual reports. LLCs have no such requirement and so are much more flexible in how they can be operated. In addition, LLCs can distribute ownership according to any agreement instead of based solely on capital put into the company. For example, an LLC can guarantee that all members receive equal share of future profits, even if the members have invested unequal amounts of money into the LLC. LLCs also enjoy several tax benefits that corporations do not. For example, LLCs get to avoid the double taxation that certain corporations can face. LLC members are only taxed on their individual incomes, whereas corporations have both their profits and dividends to shareholders taxed. In most situations, LLCs can save a lot of money by bypassing this double taxation. However, the flexibility inherent to LLCs allows them to be taxed as an S- or C-corporation under certain circumstances, which may prove to be beneficial in specific cases. Although LLCs are a novel alternative to the traditional structure of a corporation, the benefits of a corporation can still outshine the benefits of an LLC in many cases. There are many reasons to start a corporation over an LLC, but perhaps the greatest advantage corporations have over LLCs is the ability to issue stock. Issuing stock is a reliable and time-tested method of increasing investment in a business and allowing it to grow. An LLC can get along without stock, but as the business grows, investors will likely begin to want tangible ownership in the business, and that’s where stock comes in. A business owner is essentially capping the growth of their business if they decide to start an LLC instead of a corporation. Stock is not only an effective

means of raising capital and growing a business, but it also serves as a way to acquire and maintain loyal employees. By offering stock options to a business's best employees, a company can provide an incentive for employees to not only work hard for the business but to remain working for the business. Other benefits corporations have over LLCs are the ability to leave money in the corporation (as opposed to all profits going directly to members and being taxed), the ability to provide benefits to shareholders who are also employees (and deduct the cost), and that the laws regarding corporations is much more established than the laws concerning LLCs and therefore it's easier to know how the law will react to a corporation than to an LLC.

Questions & Problems What is the distinction between a general partnership and a limited partnership? Explain why a cooperative could not claim to be a syndicate. Suppose you were asked to review and assess a franchise agreement. What responsibilities would you expect to be included in that agreement? Tracy Allen rented a home in which she had been residing since the summer of 1998. The landlord-owner of the house later failed to pay taxes on the property, and, on March 16, 2000, Hard Assets LLC acquired the property from the owner in lieu of foreclosure. When Hard Assets obtained title, it did not intend to lease the property, nor were its members aware that Allen was living at the property. Once Hard Assets became aware that Allen was residing at the property, Hard Assets advised her and her family that they were not supposed to be there and that they had 30 days to vacate the premises. After 30 days, Allen had not vacated the property. While residing at the property, the children living with Allen suffered elevated blood-lead levels and were allegedly injured from lead paint exposure. As a result, the children's mother filed a suit against one of the members of the LLC for violations of the city's housing code and negligence. Should the member of the LLC be held personally liable for the alleged injuries of the children who lived at Allen's home? Why or why not? Source: Allen v. Dackman, 964 A.2d 210 (2009). Page 516P is a residential development company with a single member. The member's responsibilities "were to locate and purchase property, and then work with engineering companies and municipalities to have the property zoned and fully developed for residential living." P entered into a contract with D to excavate a property purchased by P. The member

signed on behalf of P, and D signed on behalf of himself (Perrin) and Perrin Excavating. Shortly thereafter, Duray Development and Perrin entered into a new contract, which was supposed to supersede the former contract. This contract was between Duray Development and Outlaw—which is an excavation company that Perrin and Vining owned. Perrin and Vining signed the new contract on behalf of Outlaw. They both also held themselves as owners of Duray Development as well. D then began excavation, but did not perform as expected on time. Duray Development then sued D for breach of contract. D later learned that Outlaw did not obtain an adequate filing status as an LLC in time, thus Outlaw was not a valid LLC at the time of the second contract. D argues he isn't personally liable because he signed on behalf of Outlaw, which was treated by all parties as a properly formed LLC. In so doing he cites the de facto corporation doctrine. Limited Liability Act— "the existence of the limited liability company begins on the effective date of the articles of organization . . . the document is effective at the time it is endorsed." However, the Michigan Supreme Court stated that once the articles of operation are executed and acknowledged, they are a de facto corporation. The idea is to prevent a poorly formed corporation from not being recognized as a corporation because of the defect when the parties acknowledged and believed it to be one. What ambiguity in this Michigan Supreme Court decision is likely to lead to further litigation to sharpen the boundaries of this decision? Source: Court of Appeals of Michigan, 792 N.W.2d 749 (2010). Mike Karimi has been in the hotel management business since the 1980s. The name of Karimi's company is MAK LLC, which manages and operates several hotels in the United States. In 2004, two brothers, the Khatris, who were friends of Karimi's, wanted him to take over the operation of one of their hotels. The problem with the hotel was that only 40 out of the 186 hotel rooms were suitable for guests to inhabit. This concerned Karimi, who nevertheless agreed to take over the hotel. Karimi received the rights to the hotel from the previous leasers. The hotel, Red Lion, wrote up a franchise agreement with Karimi. In the agreement, it states: "An 'Event of Default' will occur if you fail to satisfy or comply with any of the obligations, requirements, conditions, or terms set forth in this Agreement, the Manual, or any attachment to this Agreement. An 'Event of Default' will also occur if you make any misrepresentations to us, whether in entering into this Agreement, or in the performance of your obligations to us." After the renovations were underway, a representative of Red Lion Hotels decided to tour the hotel to check on the renovations. This representative decided that the hotel looked "old and tired." In early 2008, Red Lion sent Karimi a "notice of default and termination." Did Red Lion have the right to send this notice to

Karimi? Source: Red Lion Hotels Franchising Inc. v. MAK, LLC, 663 F.3d 1080 (2011). Brothers Aurelio and Hugo V. Garcia founded a trash removal business called Garcia's Inc. in the early 2000s. Hugo served as president and director. Garcia's decided to lease trucks and equipment to United Leasing. However, United required, as a part of the agreement, that the stock of Garcia's would be collateral and that United could vote Garcia's share in the company if Garcia's defaulted. Suddenly, United claimed that Garcia's had defaulted, and United liquidated the company's assets and took control. James C. Lehner, a former employee of United, formed the Lehner Family Business Trust in 2005, and shortly thereafter, Lehner offered Hugo $50,000 to assign all claims against United to the trust. Hugo executed the requested assignment, which assigned all of the legal claims, rights, and causes of action that Garcia's, "a Virginia corporation in dissolution," and Hugo, "individually and as trustee in liquidation for Garcia's, Inc.," had under the equipment leases with United and otherwise. The Lehner Trust sued United Leasing for breach of contract, claiming that "[b]y assignment, the Trust acquired all of Garcia's claims, causes of action, choses in action, rights of action, rights and interests against [United Leasing] and all claims and rights, etc., relating to the Garcia's Leases." Also, the trust claimed that United had been secretly holding over $1 million from Garcia's, which rightfully deserved it. Was the Trust right in suing United Leasing? Source: United Leasing Corp. v. Lehner Family Business Trust, 279 Va. 510 (2010). 1-800-Got Junk? is a junk removal franchise business headquartered in Vancouver, British Columbia, Canada. In late 2003, Got Junk entered a franchise agreement with Millenium Asset Recovery Inc. The agreement stated that the franchisee, Millennium, would pay a percentage of its gross revenue to Got Junk on every junk removal job it performs. In 2007, Got Junk terminated Millennium's franchise on the grounds that Millennium deliberately had not reported certain jobs and the gross revenue derived from such jobs. Was Got Junk right in terminating the agreement? Why or why not? Source: 1-800-Got Junk? LLC v. Superior Court (Millennium Asset Recovery, Inc.), Cal.App.4th, Second Dist., Div. Three. (2010). Page 517Yumilicious, a company that franchises frozen yogurt restaurants in Texas, entered a franchising agreement with Why Not, LLC. The agreement was also personally guaranteed by the principals of Why Not, Matthew Barrie, and Kelly and Brian Glynn. The agreement franchises two Yumilicious frozen yogurt stores in South Carolina. Why Not faced difficulties turning a profit, partly because a supply agreement negotiated by Yumilicious fell through which meant Why Not could not economically purchase supplies in South Carolina. As a result of its difficulties, Why Not closed one of its stores

without permission from Yumilicious and failed to make payment for royalties and products. Yumilicious subsequently sued. Why Not countersued Yumilicious, alleging that it had violated the Texas Deceptive Trade Practices Act, specifically the provision that made it illegal for a franchisor to "represent[] that goods or services have . . . characteristics [or] benefits . . . which they do not have" or to "fail[] to disclose information concerning goods or services which was known at the time of the transaction if such failure to disclose such information was intended to induce the consumer into a transaction into which the consumer would not have entered had the information been disclosed." As proof of the violations, Why Not alleged that Yumilicious had failed to provide an updated Franchise Disclosure Document. Furthermore, the Franchise Disclosure Document that was provided underestimated start up costs and failed to mention the out-of-state supply agreement that would supply Why Not could fall through. Which category of franchise does the franchise in this case fall under? How did the court rule on Why Not's counterclaims and what was its reasoning? Source: Yumilicious Franchise, LLC v. Barrie, 819 F. 3d 170 (2016). In April 2008, The First Pentecostal Church of Beaumont settled an insurance claim for property damage from Hurricane Rita. The church received $1,094,611.02. During this time, the church was embroiled in a sexual harassment lawsuit. Concerned that the settlement money could be targeted in the lawsuit, Lonnie Treadway, the pastor of the church, decided to let its defending law firm, Lamb Law Firm, P.C. hold the settlement money. The money was deposited into an account in Lamb's name. However, over the course of a year, the funds were transferred by Kip Lamb, the owner of Lamb Law, to a separate account held by Lamb Law. The funds totaling $1.2 million were spent for Kip Lamb's personal expenses and Lamb Law's operating expenses. In 2011, Leigh Parker, an attorney contracted by Lamb Law to work on the church's case, informed the church's board of trustees. Parker had known that Lamb had spent the funds since the summer of 2010 but had not informed the church until the church had requested the transfer of the settlement funds. In 2012, the church sued Lamb and Parker. Lamb also faced criminal charges and was eventually sentenced to fifteen years in prison. In its case against Parker, the church asserted that Parker was jointly and severally liable to it because he was part of a joint venture with Lamb, among other things. Specifically, the church argued that Parker and Lamb were part of a joint venture to misappropriate the church's money and then hiding the fact. What are the four elements of a joint venture as listed by the Texas Supreme Court in this case? The court ruled against the church for this argument. What was its reasoning? Source: First United Pentecostal v. Parker, 514 SW

3d 214 (2017). In 2006, Kenneth and Carol McLeod borrowed $771,000 and secured the loan with a deed of trust on their Arizona home. The deed of trust was held along with others in a trust created to hold such security interests. Deutsche Bank National Trust Company was the trustee of the trust that the McLeod's deed of trust was held by. In 2008, the McLeods had defaulted on the loan and were notified of a trustee's sale set for August of that year. The McLeods sued to enjoin the sale and while the sale was halted, the suit continued for many years. The McLeods originally named 10 defendants, including Deutsche Bank. Relevant to this case, the McLeods did not name defendant Deutsche Bank in its capacity as a trustee. By 2014, Deutsche Bank was the only remaining defendant in the case. Deutsche Bank argued that its only relation to the McLeods was as a trustee of the trust that held their deed of trust. Although the court recaptioned the remaining defendant in this case "Deutsche Bank as Trustee," it ruled that a default judgement in 2008 against another defendant similarly enjoined Deutsche Bank from foreclosing the property. Deutsche Bank appealed. Deutsche Bank argued that the trust that held the McLeods deed of trust was a common law trust, meaning it could not sue nor be sued. The only way to bring an action against the trust, Deutsche Bank argued, was to sue the trust's trustee. The appellate court vacated the previous judgment and remanded the case back to the lower court. What is the differ-ence between a common law trust and a business trust according to the judge? Why do you think business trust and common law trusts exist separately? Source: McLeod v. Deutsche Bank National Trust Company, Ariz: Court of Appeals, 1st Div. (2017).

Part 7 Business Organizations CHAPTER 22 Corporations: Formation and Organization Page 518 CASE OPENER The Formation of the Facebook Corporation On October 28, 2003, Mark Zuckerberg was a sophomore at Harvard University when he created a website called Facemash that was similar to an existing web service called Hot or Not. However, the following semester, in 2004, Zuckerberg began working on new code for a new website to be called Facebook. His friends Eduardo Saverin, Dustin Moskovitz, Andrew McCollum, and Chris Hughes joined Zuckerberg to promote the new social networking site. Membership on the site quickly grew

from only students at Harvard College to students at most universities in the United States. In the summer of 2004, Facebook was incorporated. As a corporation, Facebook is an artificial person, a status with legal ramifications for both the corporate entity and its owners. What are the legal implications of Facebook's status as a corporation? How are corporations formed? What factors should a businessperson consider in forming a corporation? LEARNING OBJECTIVES LO 22-1 Recall the powers granted to corporations by the states. LO 22-2 Summarize the process of formation of the corporation. LO 22-3 Explain the role of a director, an officer, and a shareholder in a corporation. LO 22-4 List the duties of a director, an officer, and a shareholder in a corporation. LO 22-5 Summarize the liabilities of a director, an officer, and a shareholder in a corporation. LO 22-6 Explain the rights of a director, an officer, and a shareholder in a corporation. Page 519 This chapter explains the steps necessary to establish a corporate entity. Although state law generally governs corporations and each state has its own corporate regulatory statutes, the Revised Model Business Corporation Act (RMBCA) is the basis of most state statutes. More than 25 states have adopted at least part of RMBCA. In addition, the chapter describes the legal relationships among the many groups of individuals with various priorities and agendas within a corporation. Not surprisingly, these priorities and agendas often come into conflict. To ensure that individuals, corporations, and the public achieve fair outcomes to conflicts within corporations, statutory laws have been designed to delegate particular roles, duties, and rights to each group of individuals within corporations.

Characteristics of Corporations How are corporations different from other forms of business organization? Legal Entity In U.S. law, corporations are legal entities. In other words, corporations exist separately from their shareholders. Thus, corporations can sue or be sued by others. Rights as a Person and a Citizen Courts consider corporations to be legal persons. Thus, in most cases, corporations, like natural persons, have certain rights according to the Bill of Rights. Specifically, the Fifth and Fourteenth Amendments state that government cannot deprive any person of life, liberty, or property without due process. Courts have held that corporations are persons in this case and thus have a right to due process. Furthermore, courts consider corporations to be persons with respect to the Fourth

Amendment. Hence, the Fourth Amendment protects corporations from unreasonable searches and seizures. Finally, courts consider corporations to be persons that have free-speech rights protected by the First Amendment. Creature of the State State incorporation statutes establish the requirements for corporate formation. Each individual corporation’s charter creates a contract between that corporation and the state. Limited Liability Because corporations are legal entities distinct from their shareholders, corporations are liable for corporate actions. Shareholders’ liability, therefore, is limited to their investment in the corporation. For example, in 1977, Big O Tire Dealers sued Goodyear Tire & Rubber Company. Big O Tire accused Goodyear of copying its BIGFOOT trademark on new tires. The court agreed and awarded Big O Tire several million dollars in damages. The Goodyear corporation, and not individual Goodyear shareholders, paid the damages. Although payment of damages to Big O Tire may have reduced the dividends shareholders received, the court did not hold the shareholders individually liable for any portion of the award. Free Transferability of Corporate Shares Generally, shareholders can freely transfer their corporate shares. For example, shareholders can sell their shares or give them to charity. Perpetual Existence The life of a corporation does not end when the lives of its owners end. If shareholders die, corporations do not dissolve. Similarly, if corporate directors or officers withdraw or die, the corporation continues to exist. In some cases, the articles of incorporation, a document a corporation files with the state explaining its organization, may include a restriction on the duration of the corporation. Otherwise, in most states, corporations continue to exist indefinitely. Page 520 A small number of states, however, set a maximum length of existence for corporations. After the maximum duration expires, corporations must formally renew their corporate existence. Centralized Management Unless the articles of incorporation specify otherwise, shareholders do not participate in corporate management. Instead, shareholders elect a board of directors. The board, in turn, selects officers to manage the day-to-day business of the corporation. Corporate Taxation Because corporations are separate legal entities, government taxes their income directly. (S corporations are an exception; this chapter discusses them, and their tax advantages, in detail later.) Corporations must pay federal and state taxes on their income. Corporations, however, have control over their income. Corporations can distribute their income to shareholders in the form of dividends, although they do not receive tax deductions for distributing these dividends. When corporations distribute income to shareholders, the shareholders pay taxes on that income. Because the corporation pays income taxes and the shareholders are also paying taxes on

their dividends, the dividends are subjected to double taxation, thus creating a disadvantage for corporations. Alternatively, corporations can keep profits, or retained earnings, to reinvest. Corporations' investment of retained earnings can lead to higher stock prices, thus benefiting shareholders when they sell their stock. BUT WHAT IF? . . . WHAT IF THE FACTS OF THE CASE OPENER WERE DIFFERENT? Let's say in the Case Opener that after Zuckerberg had Facebook incorporated, he and the other corporate shareholders were on a private jet when it crashed, killing all the travelers. Without any of the shareholders, what would happen to Facebook? Does the state or federal government put a limit on how long a corporation can exist? Liability for Officers and Employees LO 22-1 Recall the powers granted to corporations by the states. Because the relationship between corporations and their directors, officers, and employees is an agency relationship, corporations are liable for torts and crimes committed by their agents during the scope of their employment. Courts refer to this liability as the doctrine of respondeat superior (Latin for "let the master answer"). Although in the past courts were reluctant to impose criminal liability on corporations, prosecutions today are much more common. Exhibit 22-1 presents a summary of nine characteristics of corporations. Exhibit 22-1Characteristics of Corporations Separate legal entity Status as "legal person" and "citizen" Creature of the state Limited liability of shareholders Free transferability of corporate shares Perpetual existence Centralized management separate from owners Unique taxation method Corporate liability for torts and crimes of agents

Corporate Powers Because corporations are creatures of the state, they have only those powers states grant them. States give powers to corporations through state incorporation statutes and through each corporation's articles of incorporation. Express and Implied Powers State incorporation statutes typically grant the following express powers to corporations: the power to have perpetual existence, the power to sue and be sued in the corporation's name, the power to acquire property, the power to make contracts and borrow money, the power to lend money, the power to make charitable donations, and the power to establish rules for managing the corporation. In addition, corporations may take whatever actions are necessary to execute these express powers. Thus, corporations have implied powers. Generally, the statement of corporate purpose in each corporation's articles of incorporation gives each corporation its implied powers. Ultra Vires Act If

corporations act beyond their express and implied powers, the act is called an ultra vires (Latin for “beyond powers”) act. Corporations commit ultra vires acts most frequently when they create contracts outside the scope of their powers. While these acts are not common, they can be very important when they do occur. Today, most state incorporation statutes permit businesses to incorporate for any lawful purpose; thus, most articles of incorporation do not limit corporate powers. Hence, the doctrine of ultra vires is much less significant today than it was in the past because very few corporate acts qualify as ultra vires. Historically, courts have ruled that ultra vires acts are null and void. More recently, however, courts have permitted corporations to use the ultra vires defense if neither party to the contract has performed the terms of the contract. Yet courts uphold ultra vires contracts if one of the parties has executed her or his part of the contract. For example, suppose a timber corporation’s articles of incorporation specified that the corporation’s purpose was to harvest and sell timber. Suppose further that the directors of the corporation entered into an ultra vires contract with a machinery company to purchase machines to mine coal on the corporation’s cleared land. As long as the machinery company has not delivered the machinery to the timber corporation, courts will hold the contract null and void. If, however, the machinery company has delivered the machinery to the timber corporation, courts will uphold the ultra vires contract and require the timber corporation to fulfill the terms of the contract. Can you see which party the court is trying to protect by upholding the ultra vires contract in this situation? If a corporation commits an ultra vires act, RMBCA provides several remedies: Shareholders may sue to prohibit the corporation from fulfilling the ultra vires contract. The corporation or shareholders may sue corporate directors or officers for the damages caused by the ultra vires act. The state attorney general can have the corporation dissolved or prevent the corporation from fulfilling the ultra vires contract.

Classification of Corporations Corporations can be classified as public or private; profit or nonprofit; domestic, foreign, or alien; publicly or closely held; S corporations; or professional corporations. Public or Private Page 522 A public corporation is a corporation created by government to help administer law. Thus, public corporations often have specific government duties to fulfill. The Federal Deposit Insurance Corporation (FDIC) is an example of a public corporation. In contrast, private persons create private

corporations for private purposes. Private corporations do not have government duties. Profit or Nonprofit Most corporations are for-profit corporations. Thus, their objective is to operate for profit. Shareholders seeking to make a profit purchase the stock these corporations issue. This profit can take two forms. First, shareholders receive dividends from the corporation. Second, the market price of the stock can increase. Shareholders can then sell their stock at a higher price than the purchase price of the stock. Nonprofit corporations may earn profits, but they do not distribute these profits to shareholders. In fact, nonprofit corporations do not have shareholders. More important, nonprofit corporations' objective is not to earn profit. They do not issue stock. Instead, nonprofit corporations provide services to their members (not shareholders). These corporations reinvest most of their profits in the business. Churches and charitable organizations are examples of nonprofit corporations. Domestic, Foreign, and Alien Corporations Every corporation is incorporated in a particular state. A corporation is a domestic corporation in the state in which it is incorporated. Many corporations, however, do business in more than one state. A corporation that does business in states other than the state in which it is incorporated must obtain a certificate of authority in each state in which it does business. A corporation is a foreign corporation in states in which it conducts business but is not incorporated. For example, the McDonald's Corporation is incorporated in Delaware but does business in all 50 states. Thus, McDonald's is a domestic corporation in Delaware and a foreign corporation in the other 49 states. An alien corporation is a business incorporated in another country. Thus, if a U.S. corporation wants to do business in Canada or Mexico, it is an alien corporation in those countries. Publicly Held or Closely Held The stock of publicly held corporations is available to the public. Thus, if you want to invest in a corporation, you could purchase stock in a publicly held corporation. Most publicly held corporations have many shareholders, and managers of these corporations usually do not own large percentages of the corporation's stock. Shareholders wishing to sell their shares do not face many transfer restrictions. In contrast, closely held corporations (also called close, family, or privately held corporations) generally do not offer stock to the general public. Shareholders are usually family members and friends who are often active in the business. Controlling shareholders typically manage closely held corporations. Because closely held corporations are often family businesses, they often maintain restrictions on the transfer of shares to prevent outsiders from obtaining control of the business. Although they account for only a small fraction of corporate assets and revenues, most U.S. corporations are closely held

corporations. Subchapter S Corporation S corporations are named after the subchapter of the Internal Revenue Code that provides for them. They are a particular type of closely held corporation. Government taxes S corporations differently from other corporations. Government taxes most corporations twice on their income: corporations must pay income tax, and shareholders must pay taxes on dividends they receive. S corporations, however, enjoy the tax status of partnerships. Thus, shareholders of S corporations report their income from the corporation as personal income. Page 523 In addition to the avoidance of double taxation, S corporations offer two more important tax advantages. First, shareholders in an S corporation are allowed to deduct corporate losses from their personal income, ultimately lowering how much the shareholders have to pay in taxes. Second, depending on a shareholder's income, choosing to be an S corporation can result in the shareholder's paying a lower personal income tax rate than what the regular corporate tax rate would be. To be classified as an S corporation, a corporation must meet certain requirements. First, it cannot have more than 100 shareholders. Second, only individuals, trusts, and (in certain circumstances) corporations can be shareholders (partnerships cannot be shareholders). Third, S corporations can issue only one class of shares, although not all shares must have identical voting rights. Fourth, all S corporations must be domestic corporations. Fifth, no shareholder of an S corporation can be a nonresident alien. Professional Corporation If a group of dentists, doctors, or other professionals wants to practice as a corporation, all 50 states permit them to incorporate. Because of the nature of professional work, however, courts sometimes alter the liability associated with such corporations. For example, courts often impose personal liability on doctors in professional corporations for medical malpractice performed under their oversight.

Formation of the Corporation LO 22-2 Summarize the process of formation of the corporation. The creation of a corporation involves two parts: general organizational activities and legal activities necessary for incorporation. Organizing and Promoting the Corporation Two groups of important players are responsible for the organization of the corporation: promoters and subscribers. Promoters Promoters begin the corporate creation and organization process by arranging for necessary capital, financing, and licenses. Promoters raise capital for the infant corporation by making subscription agreements with subscribers (investors) in which the subscribers agree to purchase stock in the new corporation. Promoters have

other organizational responsibilities besides making subscription agreements. For example, promoters prepare the corporation’s incorporation papers. Promoters can also enter into contracts as needed to establish the new corporation. For example, promoters can purchase or lease buildings for the corporation. Frank Seiberling was the promoter who founded the Goodyear Tire & Rubber Company. In 1898, Seiberling purchased Goodyear’s first plant in Akron, Ohio, with $3,500 borrowed from his brother-in-law. Seiberling also established Goodyear workers’ hourly wages between 13 and 25 cents. When problems with preincorporation contracts arise, courts generally hold promoters liable and rule that these contracts do not bind infant corporations. Courts usually hold that promoters are not agents of the infant corporation because promoters cannot serve as agents for a principal (the new corporation) that does not yet exist. Once incorporated, however, corporations can accept or reject preincorporation agreements. However, even if a corporation accepts a preincorporation agreement, courts usually still hold promoters liable for the contract. Subscribers Subscribers make offers to purchase stock in a corporation in the incorporation process. A subscriber becomes a shareholder once the corporation incorporates or accepts her purchase offer, whichever occurs first. Page 524 Selecting a State for Incorporation Next, an infant corporation must select a state in which to incorporate. Each state has different laws governing the incorporation process and different corporate tax rates. Other factors corporations consider when selecting a state for incorporation include the following: How much flexibility does the state grant to corporate management? What rights do state statutes give to shareholders? What restrictions does the state place on the distribution of dividends? Does the state offer any kind of protection against takeovers? Although most corporations incorporate in the state in which they are located and do most of their business, more than half of all publicly held corporations, including more than half of the Fortune 500 companies, are incorporated in Delaware. Decades ago, Delaware law offered extremely low corporate tax rates and granted more extensive rights to management in the event of a takeover than did other states. Thus, in the 1940s and 1950s, many corporations changed their state of incorporation to Delaware. Since then, other states have made their corporate laws more attractive to corporations. Many corporations remain incorporated in Delaware, however, because Delaware courts are highly experienced in issues involving corporate law. Closely held corporations and professional corporations, however, almost always incorporate in the state in which most of their stockholders live. Although a corporation can incorporate in only one state, it can file a certificate of

authority to do business in other states. Some states fine corporations that fail to obtain a certificate of authority before conducting business in the state. Other states fine directors and officers of these corporations directly and hold them personally liable for contracts made in the state. Once a corporation chooses a state for incorporation, it can begin the formal legal process of incorporation.

Legal Process of Incorporation Selection of Corporate Name All state incorporation statutes require corporations to indicate in the name of the corporation that the business is incorporated. Every corporation must attach Corporation, Company, Limited, or Incorporated, or an abbreviation of one of these terms, to the end of its business name. In addition, every corporation must distinguish its name from the names of all other domestic or foreign corporations licensed to do business within the state. This requirement protects third parties from confusion about similar names. Once the corporation has chosen a name, this name is subject to the approval of the state. Incorporators An incorporator is an individual who applies to the state for incorporation on behalf of a corporation. RMBCA requires only one incorporator to incorporate a business, although it permits more. Generally, the incorporators' only duty is to sign the articles of incorporation. Articles of Incorporation One of the most important elements of the corporate formation process is the articles of incorporation, a document providing basic information about the corporation. According to RMBCA, a corporation's articles of incorporation must include (1) the name of the corporation, (2) the address of the registered office, (3) the name of the registered agent (i.e., the specific person who receives legal documents on behalf of the corporation), and (4) the names and addresses of the incorporators. The incorporators must execute and sign the articles of incorporation and file the document with the secretary of state, including the required filing fee, to legally form the corporation. Once the incorporators file the document, it governs the corporation. Next, the secretary of state usually issues a certificate of incorporation, a document certifying that the corporation is incorporated in the state and is authorized to conduct business. Page 525 First Organizational Meeting After the secretary of state issues the certificate of incorporation, the shareholders meet to elect the corporate board of directors, pass corporate bylaws, and carry out other corporate business. In some cases, however, shareholders name the board of directors before the first organizational meeting and list the board members in the articles of incorporation. In these situations, the directors usually run the meeting. At

the first organizational meeting, shareholders adopt a set of corporate bylaws, or rules and regulations that govern the corporation’s internal management. The articles of incorporation determine who has the power to amend the corporate bylaws after the first organizational meeting: shareholders, directors, or both.

Potential Problems with Formation of the Corporation Most businesses incorporate to enjoy limited liability or the perpetual existence of the corporation. Shareholders enjoy these benefits, however, only if the promoters and incorporator formally and correctly incorporate the business. If the incorporator or promoters make an error or omission during the incorporation process, courts may rule that the organization is not a corporation. In this case, the organization is a defective corporation. Shareholders may be personally liable for a defective corporation’s actions. Responses to Defective Incorporation Suppose an incorporator incorrectly indicates the address of the corporate office in the articles of incorporation. Does the corporation still exist? Depending on the seriousness of the error, courts may disregard an error in the articles of incorporation by recognizing the corporation as a de jure or de facto corporation. De Jure Corporation A de jure corporation (literally, a “lawful corporation”) has met the substantial elements of the incorporation process. A corporation that has received its certificate of incorporation has met the mandatory statutory provisions and is thus a de jure corporation. Courts usually hold that corporations that make minor errors in the incorporation process still enjoy de jure corporate status. Exhibit 22-2 illustrates the process for creating a de jure corporation. Exhibit 22-2De Jure Corporation Formation Thus, even if the incorporator wrote the incorrect address of the corporate office in the articles of incorporation, courts would not revoke the corporation’s limited liability. No party can question a de jure corporation’s status as a corporate entity in court. De Facto Corporation Suppose, however, that the incorporator makes a more serious mistake or omission. For example, suppose the incorporator did not file the articles of incorporation with the secretary of state. In this case, courts may recognize the corporation as a de facto corporation (literally, a “corporation in fact”). A de facto corporation has not substantially met the requirements of the state incorporation statute, but courts recognize it as a corporation for most purposes to avoid unfairness to third parties who believed it was properly incorporated. De facto corporations, regardless of whether the state has a general corporation statute, must meet the following requirements: Page 526 The promoters, subscribers, and incorporators made

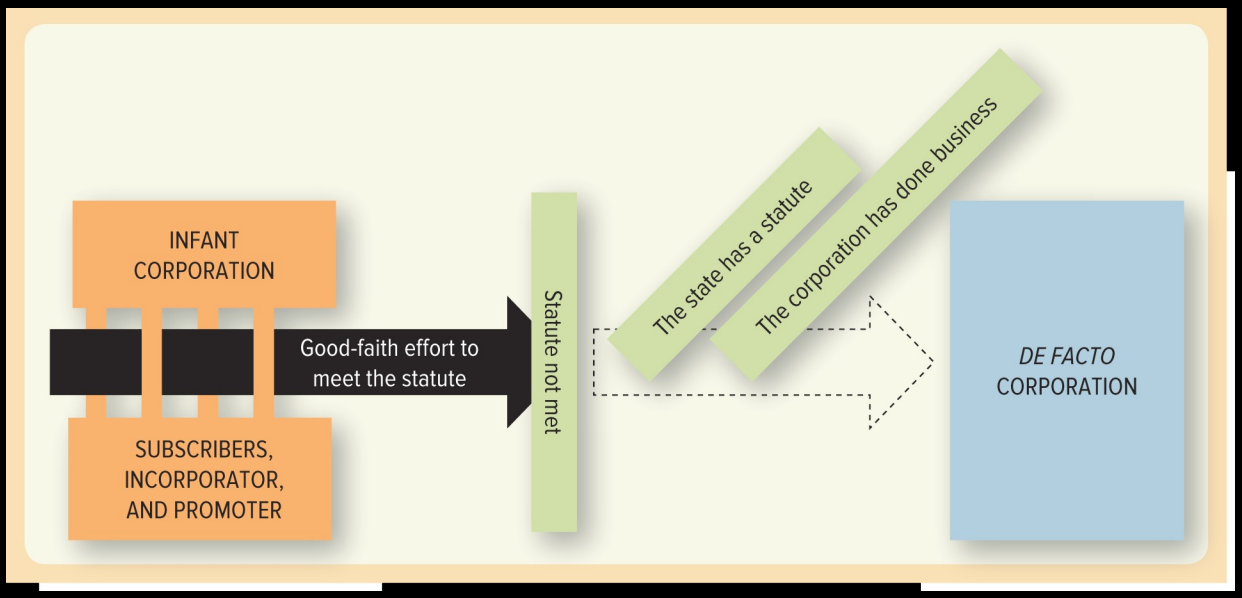
a good-faith attempt to comply with the incorporation statute. The organization has already conducted business as a corporation. GLOBAL Context Digital Archive Japan/Alamy Stock Photo Corporate Structure in China As you may expect, corporate governance varies among countries. Specifically, there are countries that have a one-tier board system (as in the United States), and there are others that have a two-tier board system. In a one-tier board, all directors (both executive directors and nonexecutive directors) form one board. A two-tier board consists of a management board (all executive directors) and a separate supervisory board (all nonexecutive directors). German corporation law, for example, requires all corporations to have two boards. In recent years, China has followed the German model and adopted a two-tier board structure, with both a board of directors and a supervisory board. Corporations following this model are required to provide in their annual reports a supervisory board report (SBR). In China, the supervisory board has significant power to supervise directors, examine financial documents, and convene shareholder meetings. In these respects, supervisors exercise substantial control over corporate managers. Although corporations in China are not required to have a supervisory board (unlike the case in Germany), there is usually a supervisory board that consists of shareholder representatives and an employee representative. However, the supervisory board does not always function at the level that many envisioned it would. In practice, supervisory boards in China have not functioned effectively because they do not have genuine power to select or discipline directors and managers. Furthermore, some critics argue that there is some overlap between the function of the supervisory board and that of the board of directors. What do you think are the advantages and disadvantages of the two-tier board system? The process for recognizing a corporation as a de facto corporation is depicted in Exhibit 22-3. Only the state can challenge a de facto corporation’s existence as a corporate entity. Exhibit 22-3De Facto Corporation Recognition Process Corporation by Estoppel Defective corporations cannot escape corporate entity status due to mistakes or omissions in their incorporation procedures. For example, suppose a corporation’s articles of incorporation do not include the name of its registered agent. Suppose further that the corporation’s directors, managers, and shareholders are unaware of the mistake. If the corporation conducts business with a third party who later sues for breach of contract, the corporation cannot claim that it is not a corporate entity to escape liability. Page 527 In such cases, courts hold that the corporation is a corporation by estoppel; thus, courts estop (prevent) the corporation from denying its corporate status. Although a court ruling of corporation by

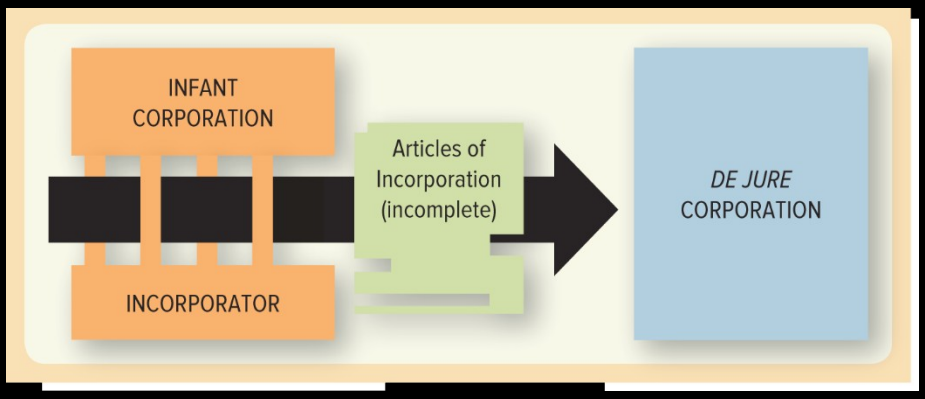
estoppel prevents the business from denying corporate status, it does not remedy the error or grant the organization corporate status for conducting future business. If a corporation makes a significant error in the incorporation process and is not a de jure or de facto corporation, and corporation by estoppel does not apply to the situation, courts usually deny the organization corporate entity status. Thus, the organization does not enjoy limited shareholder liability. BUT WHAT IF? . . . WHAT IF THE FACTS OF THE CASE OPENER WERE DIFFERENT? Let's say in the Case Opener that when filling out documents for the incorporation of Facebook, Zuckerberg's attorney became confused and wrote the wrong address for the company on the documents. Later, long after Facebook was incorporated, Zuckerberg saw the incorrect company address on the documents. Should Zuckerberg worry about the clerical error? What could be the effects of having the wrong company information on such documents? Piercing the Corporate Veil In some cases, courts will deny limited liability to a corporation that would normally have de jure or de facto status because shareholders have used the corporation to engage in illegal or wrongful acts. Shareholders attempt to hide behind the corporate veil of limited liability to protect themselves from personal liability. In these cases, courts pierce the corporate veil, or impose personal liability on shareholders. Courts are likely to pierce the corporate veil when A corporation lacked adequate capital when it initially formed. A corporation did not follow statutory mandates regarding corporate business. Shareholders' personal interests and corporate interests are commingled such that the corporation has no separate identity. Shareholders attempt to commit fraud through a corporation. For example, corporations must keep corporate funds and records separate from shareholder funds and records. If a corporation does not carefully maintain these separate records, courts may pierce the corporate veil and impose personal liability on shareholders. CASE 22-1 WOODRUFF CONSTRUCTION, LLC v. CLARK No. 17-1422 (Iowa Ct. App. 2018) FACTS: Clark Farms is an Iowa Corporation with K.W. Clark as its president, secretary, and treasurer. Clark owns and operates two other entities, Casey Clark Farm and White Pines Farm. Woodruff is a commercial industrial construction company. In 2009, Woodruff contracted with the city of Leon, Iowa, to act as general contractor during the construction of a wastewater treatment facility. In April 2010, Woodruff contracted with Clark Farms for lagoon sludge removal. Clark Farms began work, then in 2011 abandoned the project when Clark determined he had underbid the contract, leaving the work incomplete. In July 2012, Woodruff brought a breach of contract action against Clark Farms. In September 2014, Woodruff obtained a judgment against Clark Farms for $410,066.83 plus interest. Clark Farms

failed to pay the judgment. In June 2015, Woodruff brought suit to pierce the corporate veil of Clark Farms and recover personally from Clark and impose a constructive trust and equitable lien on all assets of Clark Farms. In a deposition that July, Clark stated Clark Farms still existed but was not bidding any projects and no longer had any employees aside from the bookkeeper. By the time of trial, Clark Farms had no employees. In 2017, the court denied Woodruff's request to pierce the corporate veil. Woodruff appeals. ISSUE: Should Clark Farms' corporate veil be pierced? REASONING: Plaintiffs must prove exceptional circumstances exist to warrant piercing the corporate veil. Woodruff makes several claims but primarily asserts Clark Farms was undercapitalized. Other factors claimed include failure to follow corporate formalities, failure to keep separate books, commingled finances with Clark, and that the corporation is a sham. A. Undercapitalization Undercapitalization occurs when the business's capitalization is insufficient to support the business considering its nature and the risks. When determining if a corporation is undercapitalized, we first examine the adequacy of the capital at the time of formation. We agree with the district court that Woodruff did not provide sufficient evidence to show undercapitalization at the time of the corporation's creation in 2001. The company had assets and was profitable. Nor did Woodruff provide sufficient evidence to show Clark Farms was undercapitalized at the time it entered the contract with Woodruff. No evidence presented indicates a change in the nature of the work done by Clark Farms, or an inadequately capitalized expansion. Whether Clark made capital transfers to himself which rendered the initial adequacy irrelevant is unclear from the record. It is unclear whether Clark Farms is undercapitalized based on the records provided. What was clear to the court was that the corporation was not so obviously and purposely undercapitalized by Clark so as to merit disregarding the corporate entity on its own. Despite the loan, testimony indicates Clark Farms continues to own equipment of value Woodruff may request a lien on. The court found that Woodruff had not proven Clark Farms to be undercapitalized. B. Commingled Finances Commingling of funds occurs when the same account is used to deposit fees and pay for expenses for both personal and business use. Activities such as using corporate funds for personal purposes, mixing corporate and personal accounts, and commingling assets are factors weighed under this element. Testimony from both Clark and his bookkeeper, Karen Halverson, indicate the bank account for Clark Farms was used by Clark for personal purposes and his sole proprietorships. Halverson testified in deposition that Clark would often write a check on the Clark Farms account to pay for things for Casey Clark Farms or for himself personally, and the

bookkeeper would then transfer the amount to an account receivable under Clark's name in the Clark Farms books. She explained, "It's just the way he did his business." According to Halverson, at the end of 2013, Clark owed Clark Farms $665,422. Moreover, Clark clearly testified at trial he would not make any effort to pay back any debt he did owe Clark Farms "Because the corporation is owned by me." This indicates he did not see the corporation as a separate entity from himself and did not view personal debts to the corporation as real. Separate finances are not merely the existence of an account with the corporation's name on it. Although the moneys may have been tracked, Clark clearly used the accounts for Clark Farms and Casey Clark Farms interchangeably, with no regard for which company should be providing money for expenses or benefitting from deposits. The court found Clark Farms finances were commingled with Clark's personal and sole proprietorship finances. C. Separate Books Despite the commingling of assets and funds, the corporate books may still be maintained separately. Both Clark and Halverson testified regarding the effort to identify and track the revenues and expenses relating to Clark Farms in the commingled accounts. However, nothing indicates any effort was made to track the loans and corresponding interest payments to personal or corporate loans, with Clark admitting both were tracked on the Clark Farms books. No specific records were kept tracking loans between Clark Farms and Clark and his sole proprietorships. Halverson entered periodic reconciliation entries into the Clark Farms books without further explanation to transfer moneys to Clark's other entities. Based on the evidence presented, the court found the Clark Farms books inadequately distinguished, tracked, and recorded Clark Farms corporate activities as a separate and distinct entity from Clark. D. Corporate Formalities Not Followed Clark Farms was incorporated as a domestic profit corporation under Iowa Code chapter 490 in 1997. The 1997 corporation was administratively dissolved by the Secretary of State as of August 3, 1998, due to failure to file a biennial report. Clark did not apply to reinstate that corporation, but instead refiled for incorporation. While it was dissolved from 1998 to 2001, Clark Farms continued operations as if it were active. The court found a new Clark Farms was incorporated in 2001. Clark filed the new articles of incorporation more than three years after the dissolution, on August 27, 2001, creating a new corporation carrying the same name as his prior corporation. No bylaws, corporate minutes book, or shareholder ledger were produced for the 2001 Clark Farms. Shares of the 1997 corporation were issued at the initial meeting in 1997, and Clark appears to have considered those shares as shares of the reincorporated company in 2001. No transfer of assets occurred between the two corporations. Following the

2001 incorporation, Clark appears to have treated Clark Farms in substantially the same way as his sole proprietorships. The only corporate formalities observed following reincorporation appear to be the filing of the biennial report, which was only done sporadically (but included a listing of the current registered agent and officers and directors), and the filing of taxes. Failure to follow corporate formalities, though one of the recognized factors, “does not necessarily justify piercing the corporate veil.” While the lack of corporate formalities in this instance is not sufficient on its own to disregard the corporate entity, it lends weight to other factors supporting Woodruff’s request. E. Mere Sham Woodruff claims Clark Farms was a sham corporation but treats the factor as a summary of claims regarding corporate formalities, separate books, and separate finances. While the other factors may indicate a sham corporation, a corporation can be found to be a sham even if the other factors are not met. A sham is “a false pretense[;] ... something that is not what it seems; a counterfeit.” A corporation is a sham when it has no business or corporate purpose. A sham corporation must be an “instrumentality of, or conduit for” the owner to justify piercing the corporate veil. The district court correctly examined whether Clark Farms was a mere instrumentality of or conduit for Clark. The evidence clearly shows Clark Farms was a real, if failing, business. The court agreed with the district court that the corporate entity was not a sham. Based on these five factors, the court determined the corporate veil should be pierced. Therefore, the district court’s ruling was reversed. DECISION AND REMEDY: REVERSED and REMANDED. SIGNIFICANCE OF THE CASE: This case examines some of the factors courts consider when determining whether to pierce the corporate veil. CRITICAL THINKING What reasons explain why courts would be reluctant to pierce the corporate veil? ETHICAL DECISION MAKING As you look at the answer you gave above to the critical thinking question, which values is the court pursuing when they show reluctance to pierce the corporate veil?


INFANT CORPORATION
SUBSCRIBERS, INCORPORATOR, AND PROMOTER
Good-faith effort to meet the statute
Statute not met
The state has a statute
The corporation has done business
DE FACTO CORPORATION



Corporate Financing Corporations, like other businesses, need a source of funding. Corporations most commonly obtain financing by issuing and selling corporate securities: debt securities (bonds), which represent loans to a corporation, and equity securities (stocks), which represent ownership in a corporation. Debt Securities Debt securities, or bonds, represent loans to a corporation from another party. Bonds are usually long-term loans on which the corporation promises to pay interest. Bonds frequently list a maturity date on which the corporation must repay the face amount of the loan. Before the maturity date, however, corporations usually pay bondholders fixed-dollar interest payments on a scheduled basis. Hence, bonds are

sometimes called fixed-income securities. Equity Securities Stocks and bonds are not identical. Whereas bond owners have loaned money to a corporation, stock owners actually own part of a corporation. Thus, bond owners have no voice in corporate management; stockholders have a voice in control of the corporation. Not all corporations issue bonds, but all for-profit corporations issue stock. Common stock and preferred stock are the two major types of stock. Page 530 Preferred Stock Owners of preferred stock, or preferred shares, enjoy preferences with respect to assets and dividends. Corporations often have several classes of preferred shares. Preferred stock shares many characteristics with bonds. For example, preferred stock owners usually receive a percentage of dividends associated with the face value of their preferred stock. Furthermore, corporations pay dividends to owners of preferred stock before they pay owners of common stock. Some corporations limit preferred stock owners' voting rights. Common Stock Owners of common stock, or common shares, own a portion of a corporation but do not enjoy any preferences. A common stock owner is entitled to a portion of the corporation's dividends in proportion to the number of shares of common stock they own. Common stock owners also have the right to vote in corporate elections. Each share is usually worth one vote in corporate elections. Thus, if you own 20,000 common shares of a corporation, you have 20,000 votes. In some cases, however, most notably the election of the board of directors, corporations use a method called cumulative voting to increase the influence of shareholders who own a small number of shares. Common stock owners have the lowest priority when a corporation distributes dividends. Creditors and preferred stock owners receive dividends first. Once a corporation pays these groups, however, common stock owners have a claim to the remainder of the corporate earnings.

Importance of Regulating Interactions among Directors, Officers, and Shareholders within a Corporation The three major groups of individuals within a corporation are directors, officers, and shareholders. All three groups have different interests, and, in many situations, the interests of one group conflict with the interests of another. Statutory law provides rules to ensure that the directors, officers, and shareholders within a corporation work together to the benefit of all involved. Although directors and officers play different roles within the corporation, they share the same goal. Both directors and officers attempt to ensure that their institution survives and

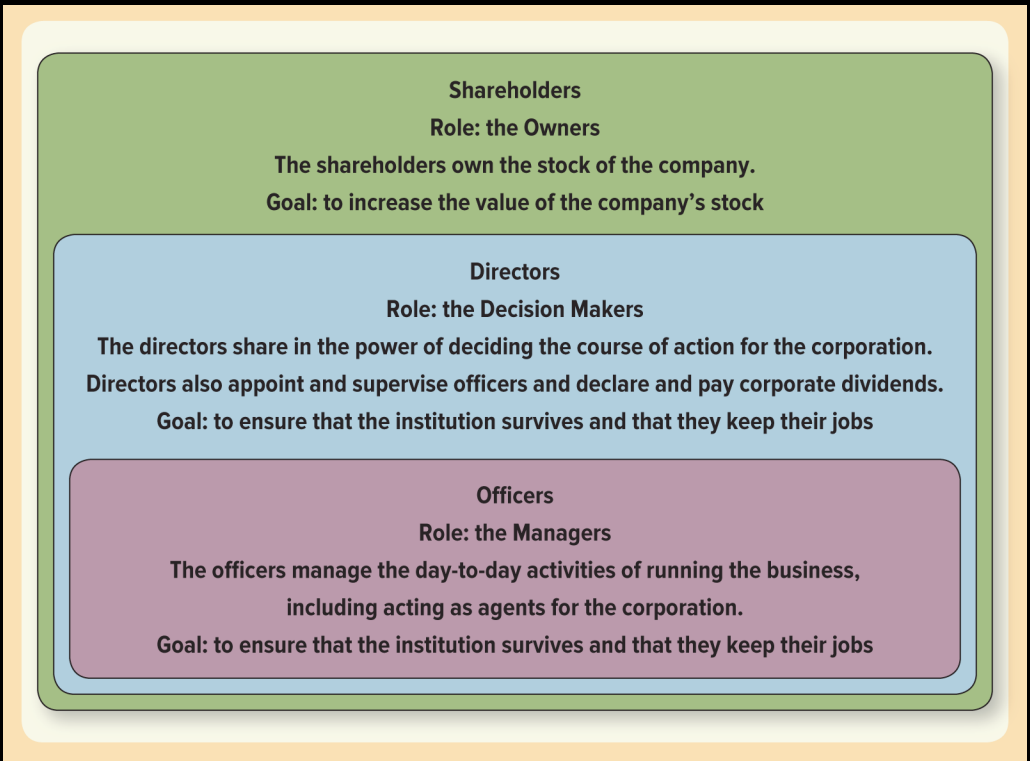
that they keep their jobs. Shareholders, on the other hand, have a different agenda. Their goal is to raise the value of the company’s stock. These different agendas can lead to conflict within corporations. If a corporation has an opportunity to make a decision that will raise the value of its stock quickly, shareholders will push the directors and officers to make this decision. However, if the directors and officers believe that the decision might jeopardize their jobs, they will resist the pressure of the shareholders. To resolve these conflicts, the law gives legal duties and rights to different groups within the corporation.

Roles of Directors, Officers, and Shareholders LO 22-3 Explain the role of a director, an officer, and a shareholder in a corporation. Before discussing the duties and rights of each position within the corporation, it is important to understand the specific roles that directors, officers, and shareholders play. The rights and duties of each group of individuals depend on these roles. Page 531 Directors’ Roles Directors play a vital role within every corporation. When a corporation faces important decisions, the board of directors meets to decide what course of action the corporation will take. Elections Typically, shareholders use a majority vote to elect directors. The only exception occurs during incorporation. Because there are no shareholders in the beginning, either the incorporators appoint board members or the corporate articles name the board members. This first board then serves until the first shareholder meeting, at which the shareholders elect a new board. The corporate articles or bylaws specify the number of corporate directors. In the past, the minimum number of directors required was three, but today many states allow fewer. In fact, if a corporation has fewer than 50 shareholders, Section 7.32 of RMBCA allows companies to eliminate the board of directors altogether. Interestingly, almost anyone can become a director. The legal requirements for director qualification are incredibly lax. In most states, directors are not even required to own stock in the corporation. In some cases, however, statutory law and corporate bylaws require not only ownership but also a minimum age. Directors typically serve for one year, but most state statutes allow for longer terms if the terms of the various directors are staggered. These terms can be terminated and the directors can be removed from their positions for cause—for failing to perform a required duty. Directors who are removed for cause, however, can ask the

courts to review the legality of the removal. Meetings and Voting A minimum number of directors, or a quorum, must be present at each meeting of the board of directors for decisions made at the meeting to be valid. Quorum requirements are different in each state, but most states leave the decision up to the corporation itself. Because a quorum is required at each meeting, directors are notified whenever special meetings are called. Directors vote in person, and each director has one vote. Although ordinary decisions require a majority vote, more important decisions sometimes require a two-thirds majority vote. Directors as Managers Although directors meet to vote on major decisions about the corporation, they are also responsible for many day-to-day managerial activities of the company. The directors appoint, supervise, and remove corporate officers as they see fit, and they declare and pay corporate dividends to shareholders. They are also responsible for making financial decisions and authorizing corporate policy decisions. Some directors are also officers or employees of the corporation; these directors are known as inside directors. Directors who are not officers or employees of the corporation are called outside directors. Outside directors are further divided into two groups: affiliated directors and unaffiliated directors. Affiliated directors have business contacts with the corporation; unaffiliated directors do not. Because the day-to-day tasks of a corporation can be overwhelming for a small board of directors that has larger issues to address, directors often appoint an executive committee to handle day-to-day responsibilities. Officers’s Roles Officers are executive managers whom the board of directors hires to run the organization. Although directors are in charge of major policy decisions, officers run the day-to-day business of the corporation. Officers act as agents of the corporation; thus, the rules of agency apply to their work. Qualifications required of officers are set forth in the corporate articles and bylaws of each corporation, but, in most cases, an individual may serve as both a director and an officer. Many corporations find it beneficial to include an officer on their board of directors so that the board can stay in touch with the day-to-day operations of the company. Page 532 Shareholders’ Roles Shareholders own the firm. As soon as an individual purchases the stock of a particular corporation, they become an owner of the corporation. Although they are not legally recognized as an owner of corporate property, they have an equitable, or ownership, interest in the company. Shareholders are not directly responsible for the daily management of the corporation, but they elect the directors who are responsible for that management. Power of Shareholders The articles of incorporation established within each corporation and general incorporation law in each state grant shareholders certain powers within the institution.

Because shareholders must approve major corporate decisions, they are, in a sense, empowered to make major decisions for the corporation. Their most influential power, however, is the power to elect and remove members of the board of directors. The board of directors is responsible for making crucial policy decisions for the corporation, and the shareholders have the power to decide who the directors will be. Shareholders also have the power to propose ideas for the corporation. If a shareholder feels that they have a worthwhile idea for the company, they can include their proposal in the proxy materials sent out to the shareholders before their annual meeting. The Securities and Exchange Commission (SEC) has established that any shareholder who owns more than $1,000 worth of stock in the corporation can submit proposals to be included in proxy materials. Meetings Typically, shareholders meet once a year, but in emergencies, they can meet more often. The board of directors, shareholders who own at least 10 percent of the corporation's outstanding shares, and others authorized in the articles of incorporation may call a special shareholder meeting. Before each meeting, each shareholder receives notice of the time and place of the meeting. If the meeting is a special meeting, the purpose of the meeting is also included in the notice. Like directors' meetings, shareholder meetings require a quorum. Generally, a quorum of shareholders exists when shareholders holding more than 50 percent of the outstanding shares are present. Once a quorum is present, a majority vote of the shares represented at the meeting is required to pass resolutions. Occasionally, however, articles of incorporation include supermajority provisions, which state that more than a majority is needed to pass major corporate proposals, such as corporate merger or dissolution. Voting Like directors, each shareholder is entitled to one vote per share in most instances. Corporations practice unique voting processes, however, that alter the influence of each shareholder's votes. These voting processes are especially important for minority shareholders within a corporation. One voting process required in most states, called cumulative voting, ensures that minority shareholders have a voice in electing the board of directors. The cumulative-voting process divides shareholders into majority and minority shareholders, and each group has a certain number of votes to cast in the election. The number of votes is determined by multiplying the number of shares the group owns by the number of open director positions. If a company is electing eight directors and the minority shareholders own 2,000 shares, the minority shareholders get 16,000 votes to cast in the election. If the majority shareholders in the same corporation own 8,000 shares, they get 64,000 votes. Although it may seem that the minority shareholders have little influence in the election, the cumulative-voting

process permits them to vote at least one director onto the board because they can cast all of their votes for one candidate. If the majority shareholders wish to elect all eight directors from their nominees, each nominee must receive more than 16,000 votes to beat the 16,000 votes of the minority nominee. However, because the majority shareholders have only 64,000 votes to cast in the election, they cannot cast more than 16,000 votes for eight candidates (16,000 × 8 = 128,000). Thus, if the minority shareholders cast all of their 16,000 votes for one candidate, they guarantee that candidate's election. Cumulative voting is more egalitarian than simple majority voting because it ensures that every voice within the corporation is heard. Cumulative voting, however, occurs only when the corporation's articles of incorporation provide for it. Exhibit 22-4 summarizes the respective roles of directors, officers, and shareholders.


Shareholders
Role: the Owners
The shareholders own the stock of the company.
Goal: to increase the value of the company's stock
Directors
Role: the Decision Makers
The directors share in the power of deciding the course of action for the corporation.
Directors also appoint and supervise officers and declare and pay corporate dividends.
Goal: to ensure that the institution survives and that they keep their jobs
Officers
Role: the Managers
The officers manage the day-to-day activities of running the business,
including acting as agents for the corporation.
Goal: to ensure that the institution survives and that they keep their jobs

Duties of Directors, Officers, and Shareholders LO 22-4 List the duties of a director, an officer, and a shareholder in a corporation. Because all individuals within a corporation depend on one another, the law requires directors, officers, and shareholders to perform certain duties within the business. In other words, individuals within the corporation have legal

responsibilities to the corporation. These duties to the corporation are called fiduciary duties. Because individuals play different roles within the corporation, the fiduciary duties of individuals depend on whether they are directors, officers, or shareholders. Duties of Directors and Officers Because the owners of the corporation, the shareholders, have little input in the day-to-day operations of the corporation, they trust the directors and officers to run the company to the best of their ability. Thus, directors and officers have duties to the shareholders and to the corporation. The two primary fiduciary duties of directors and officers are the duty of care and the duty of loyalty. Duty of Care Directors and officers have a fiduciary duty of care, meaning that they must exercise due care when making decisions for the corporation. The phrase due care is ambiguous, and various courts have interpreted it differently over time. In general, however, acting with due care requires one to exercise the care that an ordinary prudent person would exercise in the management of her own assets. Because directors and officers have a duty to act in the best interest of the company, they must supervise, to a reasonable extent, employees who work for the corporation. They also have a duty to attend director and corporate business meetings. Most important, however, directors and officers have a fiduciary duty to make informed and reasonable business decisions. Page 534 For example, recall the dramatic fall of the Texas energy company, Enron. At Enron’s peak, its shares were worth $90.75, but after the company declared bankruptcy on December 2, 2001, they plummeted to $0.67 by January 2002. Directors and officers of Enron failed in their duty of care with regard to their shareholders by not acting in the best interest of the company. The directors and officers continued to urge employees to invest in the employee stock-sharing options, even though it appears that the directors and officers knew the stock was drastically overpriced. Furthermore, the directors and officers failed in their duty of care regarding oversight. They either did not pay enough attention to see the collapse of the company’s stock coming or purposely kept the information secret. Either way, the directors and officers at Enron breached their fiduciary duty of care and therefore are liable to their shareholders, many of whom were employees of Enron. E-Commerce and the Law When a B2B Company Cooks the Books When a business student thinks about companies that cook the books, it is not surprising that companies such as Enron, Tyco, and Adelphia come to mind. Issues related to the duty of care of officers and directors are expressed in questions such as, “Why did the officers and directors of the company fail to realize accountants were cooking company books? Were any officers or directors involved in the fraud?” Students may have to revise their images of corrupt companies by adding business-to-

business (B2B) e-commerce companies to their Enron-Tyco-Adelphia list. PurchasePro is one example of an e-commerce company that allegedly engaged in “overstating revenues, engaging in aggressive accounting practices and mismanaging corporate assets.” Basically, the company manipulated its financial records to make it look far more successful than it really was. PurchasePro, which provided a business-to-business software application that gave companies access to an online marketplace, went bankrupt in September 2002. Federal prosecutors charged company officers and directors with conspiracy, securities fraud, and obstruction of justice. Two senior officers, Jeffrey R. Anderson and Scott H. Miller, pleaded guilty to federal crimes in 2003. Their behavior was similar to that of officers of other, more well-known companies that have cooked the books—they had secret side deals with purchasers that gave the appearance of sales, but the sales did not exist; they misrepresented the company’s financial health, so investors could not make informed decisions; and, when news of alleged fraud surfaced, the officers used their energy to shred incriminating documents. Directors and officers are expected to stay abreast of all important corporate matters. In other words, they must obtain information about business transactions, review contracts, read reports, and attend presentations. Because some directors are too busy to stay informed on every subject, RMBCA allows directors to make decisions on the basis of information gathered by other employees. The decisions that corporate directors and officers make must not only be informed, however, but also be reasonable. If a director or officer is taken to court for breaching his duty of care by making an unreasonable decision, the court typically inquires whether the decision had any rational business purpose. In other words, the courts ask whether there was good reason to think that the decision could have helped the company. Part of the duty of care a director or officer owes a corporation, as was previously stated, is to act in the corporation’s best interest. Therefore, when the corporation is doing something the director or officer does not think is in its best interest, it is up to them to voice their dissent. Duty of Loyalty Because directors and officers have great decision-making freedom, they have the power to make business decisions that will benefit themselves while harming the company. Thus, to protect shareholders, directors and officers have a fiduciary duty of loyalty. In other words, they have a fiduciary duty to put the corporation’s interest above their own when making business decisions. When directors or officers violate their duty of loyalty, they are self-dealing. There are two types of self-dealing in which a director or officer can engage. The first form of self-dealing, called business self-dealing, occurs when a director or officer makes decisions that

benefit other companies with which they have a relationship. The second form of self-dealing, called personal self-dealing, occurs when a director or officer makes business decisions that benefit them personally. When Enron directors and officers advocated employees buying more Enron stock so that the directors and officers would make more money, they engaged in self-dealing in breach of their fiduciary duty of loyalty. Page 535 CASE Nugget How Should Directors Handle Personal Interests That Conflict with Corporate Interests? Patrick v. Allen United States District Court, S.D. New York 355 F. Supp. 2d 704 (2005) RPO, a privately traded corporation, rented land to a private golf course of which several of RPO's directors were members. The directors charged the golf course enough rent to cover only the property taxes on the land. Patrick, a shareholder of RPO, brought a suit against the directors of RPO, alleging that RPO's directors breached their fiduciary duty of loyalty to the corporation by failing to maximize the value of the corporation for shareholders. The directors argued that they were exempt from liability under the business judgment rule. (The business judgment rule is covered in the section entitled "Liabilities of Directors, Officers, and Shareholders," which follows shortly.) The U.S. District Court for the Southern District of New York ruled against the RPO's directors, holding: The business judgment rule will not protect a decision that was the product of fraud, self-dealing, or bad faith. Directors may benefit from the rule only if they possess a disinterested independence and do not stand in a dual relation which prevents a nonprejudicial exercise of judgment. It is black-letter, settled law that when a corporate director or officer has an interest in a decision, the business judgment rule does not apply. . . . A director is considered interested in a transaction if the director stands to receive a direct financial benefit from the transaction which is different from the benefit to shareholders generally. . . . The duty of loyalty requires a director to subordinate his own personal interests to the interest of the corporation. In many situations, when a director or officer is self-dealing, they force the corporation into unfair business deals. Directors and officers can also breach their fiduciary duty of loyalty, however, by preventing corporate opportunity. This breach usually happens when directors or officers own other companies that compete with their corporation without the consent of the board of directors or the shareholders. If a director or officer uses corporate assets to start another business, goes into the same line of business, or uses their position in the company to develop a new business that the company might have pursued, they are preventing corporate opportunity and can be held liable for violating their fiduciary duty of loyalty. A director or officer convicted of breaching their duty of loyalty is required to cede to the

corporation all the profits they earned as a result of the breach. The goal of this rule is to create incentives that discourage breaches of the duty of loyalty by taking from the director or officer all the profits that they made. The fiduciary duties of care and loyalty are rooted in ethics. Without these legal duties, directors and officers could pursue their own interests at the expense of others. Through these fiduciary duties, however, the law requires directors and officers to consider the interests of others. Think back to Chapter 2 and the different ethical guidelines used to make ethical decisions. Which ethical guideline is the legal system using when it delegates fiduciary duties? Page 536 Duty to Disclose Conflict of Interest Because there are many times when individual directors and officers may personally benefit from decisions made by the board of directors, the directors and officers have a fiduciary duty to disclose conflicts of interest fully that arise in corporate transactions. Moreover, if the board of directors addresses an issue that might personally benefit a particular director, the director is required not only to disclose the self-interest but also to abstain from voting on that issue. Note that a decision can be made that will personally benefit one director or officer as long as (1) there is full disclosure of the interest and (2) the disinterested board members and/or disinterested shareholders approve the decision. Duties of Shareholders Although shareholders typically have few legal duties, in rare instances, majority shareholders have fiduciary duties to the corporation and to minority shareholders. In some corporations, the majority shareholder owns such a significant portion of the corporation’s stock that they essentially control the firm. When the majority shareholder sells their shares, control of the company shifts to another individual. Thus, the majority shareholder in this situation has a fiduciary duty to act with care and loyalty when selling their shares. As noted earlier, more than half of all U.S. publicly traded corporations are incorporated in Delaware. Thus, when Delaware courts rule on the duties of majority shareholders to minority shareholders, for example, the courts’ rulings have a far-reaching impact. In Case 22-2, a minority shareholder sued the majority shareholder of a corporation for violating its fiduciary duties. CASE 22-2 MCCANN v. MCCANN Supreme Court of Idaho 275 P. 3D 824 (2012) FACTS: McCann Ranch & Livestock Company Inc. was a closely held corporation created by William McCann, Sr. In the 1970s, Ron and Bill McCann, the creator’s sons, were each given 36.7 percent of the shares of the corporation. The remaining shares were held by the creator, William, until those shares were transferred to a trust to benefit his wife, Gertrude. The trustee, Gary Meisner, was given the power and discretion to vote and sell Gertrude’s shares under certain circumstances. Upon the death of the corporation’s creator, William, Bill

became the president and CEO of the corporation. Then, upon the death of Gertrude, Bill received her remaining shares. In June 2008, Ron, a minority shareholder, filed an initial complaint, alleging that the corporation breached its fiduciary duty owed to him as a shareholder by engaging in a squeeze-out and that such injury is grounds for a direct action. Ron's claim mentioned his treatment by the corporation as well as financial transactions of the corporation. The district court granted summary judgment in favor of the respondent, Bill. Ron appealed. ISSUE: May a minority shareholder bring suit against the majority shareholder for breach of fiduciary duty? REASONING: Squeeze-outs are actions taken by controlling shareholders to deprive a minority shareholder of his or her interest in a business or a fair return on an investment. Courts have analyzed the legality of squeeze-outs by referring to the conduct of the majority shareholders and how such conduct affects the minority shareholders. In other words, the law recognizes that directors owe a fiduciary duty to minority shareholders. In this case, the court reasoned that the conduct of the corporation could not be excused under the business judgment rule. Specifically, the corporation had not paid dividends despite sufficient cash flow, not provided board membership to Ron, authorized phony transactions to Gertrude to avoid any benefit to Ron, and had made management decisions that benefited Bill and Gertrude at the expense of Ron. The court inferred from these observations, along with the fact that Ron was specifically hurt from the payments that the corporation made to Gertrude, that a material question existed with regard to the corporation engaging in a squeeze-out. DECISION AND REMEDY: The court reversed in favor of Ron and remanded to address the questions of whether the alleged squeeze-out constituted a violation of fiduciary duties. SIGNIFICANCE: This case highlights the legal obligations of majority stakeholders to minority stakeholders because of the overwhelming power majority stakeholders have over the operation of the corporation. CRITICAL THINKING What reasons does the court give for its conclusion? Are you persuaded by those reasons? ETHICAL DECISION MAKING Clearly, the court emphasizes particular values in its ruling. What are these values? Which shareholders in the business community are affected by focusing on these values when assessing a corporation's fiduciary duties?

Liabilities of Directors, Officers, and Shareholders LO 22-5 Summarize the liabilities of a director, an officer, and a shareholder in a corporation.

Because almost all individuals within a corporation have legal fiduciary duties to the corporation, almost all individuals within the firm can be held liable for harming the business by violating these duties. Ordinarily the status of “corporation” protects shareholders and directors from personal liability for the debts of the corporation. The metaphor of “piercing” the corporate veil refers to those instances when the courts permit personal liability to attach to shareholders and directors. Liability of Directors and Officers Directors and officers are held liable for many of the same actions because they have nearly identical fiduciary duties to the corporation. A shareholder can sue them if the shareholder feels that they have caused harm to the business by violating their fiduciary duties. Directors and officers can be held liable for the torts and crimes of their employees. Liability for Torts and Crimes Although the corporations themselves are liable for the torts and crimes of their directors and officers, directors and officers can also be held personally responsible for their own torts and crimes. They can even be held personally responsible for the torts and crimes of other employees within the organization when they have failed to supervise the employees’ behavior adequately. According to the responsible person doctrine, a court may find a corporate officer criminally liable regardless of the extent to which the officer took part in the criminal activity. Even if the officer knew nothing about the criminal activity, the officer can still be held criminally liable if the court determines that a responsible person would have known about and could have prevented the illegal activity. Corporate directors and officers may also be held liable for wrongful personal transactions involving company stock. Directors and officers who use inside information to trade the corporation’s stock for a profit can be held liable for breaching their fiduciary duty to the shareholders from whom they purchase or to whom they sell the stock. Page 538 GLOBAL Context Digital Archive Japan/Alamy Stock Photo Corporate Criminal Liability in Germany In contrast to the U.S. and many other European jurisdictions, Germany does not currently recognize corporate criminal liability. Instead, corporations can receive enhanced civil penalties when a representative of the company has committed a criminal or regulatory offence. Fines typically range up to 10 million Euros, but this limit may be exceeded to include profits obtained by the illicit behavior in exceptional circumstances. However, because corporations can only be punished by civil penalties, whether a corporation is punished at all is up to the discretion of the authorities. Some Germans have criticized the system for letting corporations get away with illicit behavior whereas prosecution would be necessary under a corporate criminal liability system. In response to these criticisms and numerous corporate scandals

involving German companies (e.g., Volkswagen’s emissions scandal), the German government introduced a draft bill in 2018 outlining a corporate criminal liability regime to impose harsher sanctions on illicit corporate behavior. This bill would also make it mandatory to prosecute corporate criminal behavior. Time will tell if Germany adopts the corporate criminal liability system used by most of the Western world. Business Judgment Rule Although directors and officers are expected to make decisions that are in the best interest of the corporation, they are not expected to make perfect decisions all the time. Many directors and officers make decisions that inadvertently harm the corporation. Although shareholders may want to hold their directors and officers liable for these decisions, the business judgment rule does not allow them to do so. Under this rule, directors and officers are not liable for decisions that harm the corporation if they were acting in good faith at the time of the decision. In other words, if there was reason to believe that the decision was a good decision at the time, the directors and officers are not liable for the resulting harm. Page 539 Although the business judgment rule is not a statute, it is common law recognized by almost every court in the country. The rule is practical because it grants directors the freedom to work without constant fear of personal liability. The business judgment rule also encourages individuals to serve as directors by removing the threat of personal liability for inadvertent mistakes. CASE Nugget The Business Judgment Rule Auerbach v. Bennett N.Y. Court of Appeals 393 N.E.2d 994 (1979) An internal audit of the GTE Corporation suggested that the corporation’s management had paid more than $11 million in bribes and kickbacks both in the United States and abroad over a four-year period. Auerbach, a GTE shareholder, immediately initiated a shareholder derivative action (discussed below) against GTE’s directors. The Court of Appeals of New York, however, held that the business judgment rule exempted the GTE directors from liability for their poor business decisions. The court stated [The business judgment doctrine] bars judicial inquiry into actions of corporation directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes. Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient. The ongoing importance of the business judgment rule is demonstrated by its recent application in Case 22-3. CASE

22-3 KDW RESTRUCTURING & LIQUIDATION v. GREENFIELD United States District Court, S.D. New York 874 F.Supp.2d 213 (2012) FACTS: KDW Restructuring & Liquidation Services LLC is the trustee of a litigation trust held on the behalf of debtor Jennifer Convertibles Inc. In 2009, Jennifer had losses from a transaction between Jennifer and Jara Enterprise Inc. As a result of the loss, KDW brought an action against the members of Jennifer's 2009 Board of Directors: Harley Greenfield, Edward G. Bohn, Kevin L. Coyle, Rami Abada, and Mark J. Berman. All defendants moved to dismiss the breach of fiduciary duty claim based on the business judgment rule. Abada is a director but voted against all but the final agreement. He also consistently expressed reservations about transactions with Jara. ISSUE: What are the standards whereby a director would be judged to have violated his duties as a corporate director? REASONING: The court noted that Albada's behavior was consistent with his responsibilities as a director. They reasoned that the plaintiffs had not adequately pleaded specific facts about Abada to demonstrate that he was interested, acting in bad faith, lacking a rational purpose, or grossly negligent. Abada was not an interested party—he derived no unfair personal benefit from the transaction. His prior employment at Jara does not plausibly demonstrate that he was reaping a material personal benefit, particularly considering that he thought the deal ill-advised. Neither a bad faith nor duty of loyalty claim against this defendant is plausible. Greenfield, another director, alleged that because of the collective nature of the complaint, the allegations against him were not sufficient to support a claim. However, there were sufficient specific facts in the complaint to support claims for breach of the duty of loyalty and breach of the duty to act in good faith against Greenfield. Greenfield claimed an overly broad interpretation of the business judgment rule that shields directors whenever a majority of the board is disinterested. This formulation does not take into account the possibility that certain actions can only be explained by bad faith. Greenfield was a founder of Jara. Greenfield's sister, Jane Love, was the controlling shareholder of Jara during the 2009 transactions. He voted to continue shipping to Jara despite Jara's delinquency and corporate counsel's advice that he refrain from voting on Jara-related issues. Drawing reasonable inferences in the plaintiff's favor, these facts suggest that Greenfield may have been an interested party, on both sides of the transaction, reaping a personal benefit. As such, plaintiffs have adequately pled that Greenfield is not protected by the business judgment rule, and the breach of the duty of loyalty claim survives. DECISION AND REMEDY: Abada's motion to dismiss is granted because he is protected by the business judgment rule. Greenfield's motion to dismiss is denied because the basis for the duty to act in good

faith claim survives. SIGNIFICANCE OF THE CASE: Corporate directors need to be fully aware of the standards they must meet if they wish to use the business judgment rule to shield them from liability for potentially violating one or more of the duties owed by every corporate director. CRITICAL THINKING Are there words or phrases in the court's argument that are ambiguous? Why are these ambiguous words important? ETHICAL DECISION MAKING Suppose you were on the board of directors in this case. The universalization test guides your ethical decisions. Would you have made a different decision? Page 540 Liability of Shareholders The main liability that shareholders face is liability for the debts of the corporation. Because shareholders are the owners of the corporation, they are liable to the extent of their investment when the company loses money. There are rare instances, however, in which shareholders are personally liable. For instance, in some cases, individuals sign stock subscription agreements before incorporation. Once an individual signs a stock subscription agreement, they are contractually obligated to purchase shares in the corporation. For par-value shares, or shares that have a fixed face value noted on the stock certificate, the shareholder must pay the corporation at least the par value of the stock. For no-par shares, or shares without a par value, the shareholder must pay the corporation the fair market value of the shares. The shareholder is personally liable for breach of contract if they do not buy shares. Alternatively, a shareholder can be held personally responsible if they receive watered stock. Watered stock is stock issued to individuals below its fair market value. When watered stock is issued to a shareholder, the shareholder is individually liable for paying the difference between the price paid for the shares and the stated corporate value of the shares.

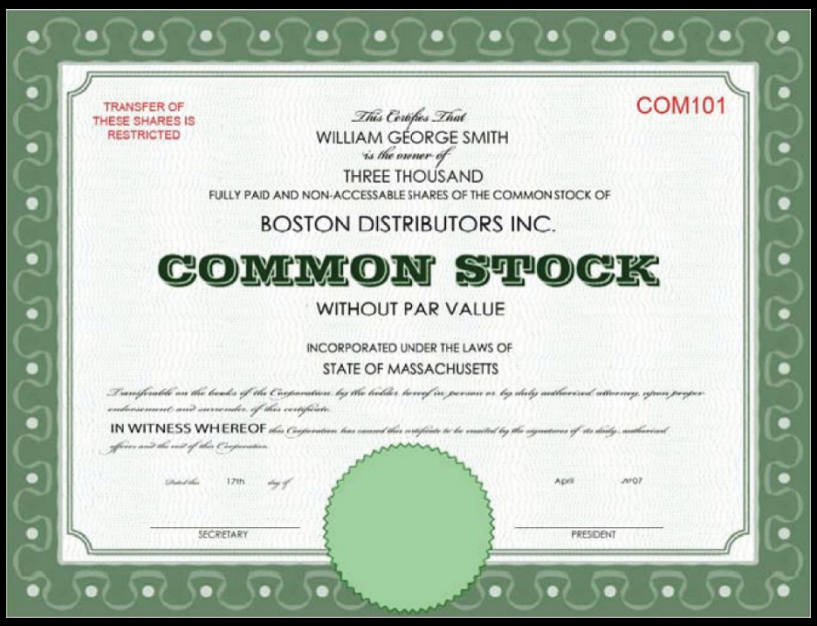
Rights of Directors, Officers, and Shareholders LO 22-6 Explain the rights of a director, an officer, and a shareholder in a corporation. Along with their specific roles and duties, directors, officers, and shareholders have specific rights within the corporation. Because shareholders are in a position of limited decision-making power, they have rights that allow them to participate within the corporation. Directors and officers also have specific rights that allow them to perform their duties within the corporation to the best of their abilities. Directors' Rights The unique responsibilities of corporate directors call for unique rights. Directors have four major rights within a corporation: rights of compensation, participation, inspection, and indemnification. All corporate directors have a right to compensation for their work, and different corporations grant compensation in different ways. Most

directors hold other managerial positions within their companies and receive their compensation through those positions. Another common avenue for compensating directors is paying them nominal sums as honorariums for their contributions to the company. Because directors are required to make informed business decisions, they have the rights of participation and inspection. In other words, they have the right to get involved in and understand every aspect of the business. A corporate director has the right to be notified of all meetings and has access to all books and records. Finally, because directors are in positions of great legal vulnerability, they have the right to indemnification. That is, they have the right to reimbursement for any legal fees incurred in lawsuits against them. Officers' Rights Because corporate officers are technically employees of the corporation, their rights are defined by employment contracts drawn up by the board of directors or the incorporators. They are in a contractual relationship with the corporation, and if they are removed from their positions in violation of the terms of the contract, the corporation may be liable for breach of contract. Shareholders' Rights Although shareholders' most powerful right is the right to vote at shareholders' meetings, they also possess many other rights. Page 541 Stock Certificates Some corporations issue stock certificate to shareholders as proof of ownership in the corporation. Each certificate includes the corporation's name and the number of shares represented by the certificate. An example of a stock certificate is shown in Exhibit 22-5. A shareholder's ownership in the corporation, however, does not depend on his possession of the physical stock certificate. For example, if the certificate is destroyed in a fire, the shareholder's ownership in the corporation is not destroyed. Exhibit 22-5Example of a Stock Certificate Preemptive Rights Under common law, shareholders have preemptive rights. Preemptive rights give preference to shareholders to purchase shares of a new issue of stock. Each shareholder receives preference in proportion to the percentage of stock they already own. For example, suppose that a shareholder owns 1,500 shares in a corporation with 5,000 outstanding shares. They own 30 percent of the corporation's outstanding stock. Now suppose that the corporation decides to issue an additional 10,000 shares. If the corporation does not grant preemptive rights, their relative control of the corporation will fall because they now own only 1,500 of the corporation's 15,000 outstanding shares, or 10 percent of its stock. In contrast, if the corporation does reserve preemptive rights, and the shareholder elects to purchase 3,000 shares of the newly issued stock, then they own 4,500 shares of the corporation's 15,000 outstanding shares (30 percent). Thus, with preemptive rights, they can maintain their proportionate control of the corporation. GLOBAL Context

Digital Archive Japan/Alamy Stock Photo Criminal Liability in France The French Penal Code does not adhere to a detailed or large list of corporate offenses but, instead, adopts what is called the specialty principal, which requires corporate criminal liability to be applicable only when an “express mention in the law or in a French regulation exists.” The French system of corporate criminal liability sharply contrasts with that of the United States in that it has often been described as scientific. This is because the French system requires heavy statistics outlining the frequency of a corporate officer’s involvement in a crime before any criminal liability may be enforced. This approach differs from the approach here in the United States because our responsible-person doctrine may require a corporate officer to be held criminally liable regardless of the extent of participation in a crime. Page 542 In most states, a corporation’s bylaws can negate preemptive rights, so the corporation determines whether to grant preemptive rights. Preemptive rights are especially important for individuals who own stock in closely held corporations due to the relatively small number of issued shares. If a closely held corporation issues additional shares, an individual shareholder may lose proportional control over the firm if they do not buy newly issued shares. However, if preemptive rights exist within the corporation, all shareholders receive stock warrant, which they can redeem for a certain number of shares at a specified price within a given time period. Dividends If directors fail to declare and distribute dividends, shareholders have the right to take legal action to force the directors to declare the dividends. In many cases, however, directors have good reason to hold dividends for a limited amount of time to finance major undertakings such as research or expansion. Thus, shareholders must show that the directors are acting unreasonably and abusing their discretion in withholding the dividend. Inspection Rights All shareholders have the right to inspection under both statutory and common law. A shareholder can, moreover, appoint an agent to conduct the inspection on her behalf. To prevent abuse, however, this right has many limitations. Shareholders can inspect records and books only if they ask in advance and have a proper purpose. Many states have other statutory limitations to this right. For example, some states allow only shareholders with a minimum number of shares to inspect. Other states require the shareholder to own stock for a minimum amount of time before inspection. Additionally, corporations can deny shareholders’ right to inspect confidential corporate information, such as trade secrets. Share Transfer The law generally permits property owners to transfer their property to another person, and, in most cases, stock is considered transferable property. In closely held corporations, however, the transfer of stock is usually restricted

so that shareholders can choose the corporation’s other shareholders. One method of restricting stock transferability is called the right of first refusal. If a corporation establishes this right in its bylaws, the corporation or its shareholders have the right to purchase any shares of stock offered for resale by a shareholder within a specified period of time. Corporate Dissolution Shareholders have the right to petition the court to dissolve their corporation if they feel the company cannot continue to operate profitably. According to Section 14.30 of RMBCA, if a corporation engages in any of the following behaviors, shareholders have a legal right to initiate dissolution: Directors are deadlocked in managerial decisions and harming the corporation. Directors are acting in illegal, oppressive, or fraudulent ways. Assets are being wasted or used improperly. Shareholders are deadlocked and cannot elect directors. Once dissolution has taken place and the corporation has settled its debts with its creditors, shareholders have a right to receive the remaining assets of the company in proportion to the number of shares they own. Shareholder’s Derivative Suit One of the shareholder’s most important rights is the right to a derivative suit. If corporate directors fail to sue when the corporation has been harmed by an individual, another corporation, or a director, individual shareholders can file a shareholder’s derivative suit on behalf of the corporation. In most jurisdictions, to be able to file a shareholder’s derivative suit, a shareholder must have held stock at the time of the alleged wrongdoing. Before filing the suit, the shareholder must file a complaint with the board of directors. If nothing is done in response to the complaint, the shareholder can proceed with the suit. Enron shareholders brought shareholder’s derivative suits against various directors and officers of Enron. Derivative suits are important when shareholders believe that directors of the corporation are harming the corporation. It seems highly unlikely that directors will sue themselves for damages they cause in such cases. Thus, the shareholder’s derivative suit is important for holding the directors accountable for their behavior. Because the shareholder files this suit on behalf of the corporation, all damages recovered are given to the corporation, not the individual shareholder. Page 543 Shareholder’s Direct Suit In addition to their right to bring suit on behalf of the corporation, shareholders can also bring a direct suit against the corporation. In a shareholder’s direct suit, the shareholder alleges that they have suffered damages caused by the corporation. For example, shareholders can bring a direct suit if the board of directors is improperly withholding dividends or if a shareholder is wrongly denied their right to inspect corporate records. If a court awards damages as a result of a shareholder’s direct suit, the damages go to the shareholder personally. Exhibit 22-6 summarizes the respective

rights of directors, officers, and shareholders. Exhibit 22-6Rights of Directors, Officers, and Shareholders POSITION RIGHT Directors Right to compensation Right to participation Right to inspection Right to indemnification Officers Rights determined in employment contract Shareholders Right to have stock certificates Preemptive rights Right to dividends Right to transfer shares Inspection rights Right to corporate dissolution Right to file a derivative suit Right to file a direct suit



Purchase of Stock Corporations can extend their operations by purchasing another corporation’s stock. An acquiring corporation, or aggressor, can buy any or all of another corporation’s voting shares. Through such a stock purchase, the purchasing corporation gains control of the selling corporation in a corporate takeover.

The Nature of Takeovers During the 1980s, not only did the number of corporate takeovers increase, but so too did the number of hostile takeovers. Hostile takeovers are takeovers to which the management of the target corporation objects. When a hostile takeover succeeds, the target corporation’s management frequently compares the transition to a full-scale

invasion characterized by layoffs and dramatic changes in company policy. Types of Takeovers To initiate a stock purchase, the aggressor must appeal directly to the shareholders of the corporation it hopes to buy, known as the target corporation. The aggressor can offer several types of deals to the target shareholders. It can make a tender offer, in which it offers target shareholders a price above the current market value of the stock. Aggressors, however, often require them to receive a certain number of shares within a certain time frame. Alternatively, the aggressor may make an exchange tender offer. In an exchange tender offer, the aggressor offers to exchange target shareholders' current stock for stock in the aggressor's corporation. The aggressor may also make a cash tender offer to the target shareholders, in which it pays them cash for their stock. After acquiring a substantial number of the target corporation's shares, the aggressor initiates a proxy fight by fighting for control over target shareholders' proxies. Before an aggressor can gain control of the target corporation through proxies, it needs a key piece of information: a list of target shareholders. Although resistant target corporations often want to conceal this information, federal securities law requires target corporations to assist aggressors in some ways. Thus, to avoid lengthy and expensive lawsuits, target corporations often provide a list of shareholders voluntarily. Page 544 Those seeking to acquire corporations have developed tactics to overcome the law's rules encouraging cooperation from target corporations. Because contacting each individual target shareholder is expensive, aggressors often try to win the favor of a few institutional investors that own a large block of shares. If an aggressor can obtain the proxies of these investors, it can win control of the target corporation. Response to Takeovers Once an aggressor has presented its offer to the target corporation's shareholders, the target corporation's board of directors must inform shareholders of all facts pertinent to shareholders' votes. After reviewing these material facts, the directors vote to accept or reject the offer and advise shareholders accordingly. If the directors conclude that a takeover is not in the company's best interest, the company may employ many methods of resistance. One common method is a self-tender offer, in which the target corporation offers to buy its shareholders' stock. If the shareholders accept the offer, the target corporation maintains control of the business. Alternatively, target corporations may defend themselves using leveraged buyouts. A leveraged buyout (LBO) occurs when a group within a corporation (usually management) buys all the outstanding corporate stock held by the public. Thus, the group gains control over corporate operations by going private, or becoming a privately held corporation. LBOs are usually high-risk endeavors, however, because the target corporation must borrow

money to purchase the outstanding stock. It may have to borrow money from an investment bank or issue corporate bonds. In Case 22-4, the U.S. Court of Appeals for the Sixth Circuit considered the legality of a golden parachute, a clause in an executive's contract specifying that they will receive large benefits if the executive's employment is terminated. Management of the target firm in this case made an agreement with its top managers to win their cooperation in resisting a takeover. CASE 22-4 CAMPBELL, KESSER, AND WILLIAMS v. POTHAS CORPORATION U.S. Court of Appeals for the Sixth Circuit 238 F.3d 792 (2001) FACTS: PCS, a Saskatchewan fertilizer corporation, approached Arcadian, a Tennessee fertilizer corporation, about a possible merger. They decided to merge, and Arcadian and PCS negotiated the terms of the merger and the severance agreements. The Arcadian board approved employment agreements for nine senior executives that included so-called golden parachutes. The "golden parachute" portion of the severance package provided a formula to compensate senior executives in case of a change in corporate control accompanied by a material change in the executive's position at the new company. In such a circumstance, the executive could leave the company and receive an aggregate payment in one lump sum. Three of the executives elected to take the severance package but were not compensated accordingly. Campbell (the former president and CEO), Kesser (the former vice president and general counsel), and Williams (the former vice president and CFO) sued PCS for breach of contract because PCS refused to make those severance payments to the executives. In response, PCS argued that the golden parachute agreements were not enforceable because they violated public policy. ISSUE: Are the golden parachutes offered to the three executives enforceable, or do they violate public policy? REASONING: PCS argued that the golden parachutes violated public policy and therefore that the assumption agreement promising them is void. However, PCS offered golden parachutes to its own top managers. Hypocrisy aside, PCS cited no circuit case law supporting this proposition. Although the court has frowned on golden parachutes in past dicta, the court has never held that such severance packages were per se unlawful. Furthermore, PCS did not provide much reason to equate this type of executive compensation with contracts prohibited by public policy, such as ones to perform illegal acts. Although PCS cited a congressional committee report saying that golden parachutes should be discouraged, Congress decided to tax golden parachutes and not prohibit them. Therefore, PCS did not cite compelling evidence that the contracts were prohibited by public policy. DECISION AND REMEDY: The court ruled that the golden parachutes did not violate public policy, and it subsequently ordered enforcement of the

severance agreements. PCS already received the benefit of the bargain it struck concerning golden parachutes in having an orderly change in corporate control, and it cannot refuse payment in return. SIGNIFICANCE OF THE CASE: This case illustrates the trouble firms can get into when they engage in mergers and severance packages. PCS made an agreement to secure the loyalty of its top management, but when the time came to fulfill its part of the bargain, the company tried to argue that enforcement of such a contract would be unfair and unenforceable. CRITICAL THINKING Is there any missing information you would ask for when considering the facts of this case? If you were to argue to reverse the trial court's decision, what reasons would you offer? ETHICAL DECISION MAKING Think about the WH process of ethical decision making. What is the purpose of the court's decision? In other words, which value is upheld? What value is in conflict with the reasoning of the court? E-Commerce and the Law Hostile Takeovers Online In the world of business, physical corporations are not the only ones who fear hostile takeovers. Companies such as Yahoo!, the Internet web browser and email hub, have recently fallen on hard times. Advertising companies have many more outlets now in which to fund advertising, which means that advertising business is being spread thin over the online realm. This market slowdown presents a problem for Yahoo because 90 percent of Yahoo's profits come from selling advertising space. Because Yahoo's stock prices have dropped dramatically, the company is worried about hostile takeover. To help prevent this from happening, Yahoo has created a poison pill. This measure means that if another company, such as Google, owns a majority of Yahoo's stock, other stockholders holding shares of Yahoo may purchase more Yahoo stock at a significantly lower price. This bargain drastically increases the price the (would be) takeover company would have to pay to complete the takeover. Yahoo may then feel a little more secure about its continued independence. Sources: http://www.forbes.com/2001/03/02/0302ecommerce.html; http://business.yourdictionary.com/poison-pill.

Response to Termination The death of a corporation occurs in two phases: dissolution, the legal termination of the corporation, and liquidation, the process by which the board of directors converts the corporation's assets into cash and distributes them among the corporation's creditors and shareholders. Dissolution Dissolution may be voluntary or involuntary,

depending on who initiates and compels the dissolution. Voluntary dissolution occurs when the directors or shareholders trigger the dissolution procedures. The directors can initiate the proposal and submit it to the shareholders for a vote, or the shareholders can begin dissolution procedures. Involuntary dissolution results when government or private parties successfully get a court order dissolving the corporation. Either way, for dissolution to be successful, shareholders must unanimously vote for the proposal. Page 546 Regardless of whether the directors or shareholders initiate dissolution, the corporation must follow specific procedures. First, the directors must file articles of dissolution with the secretary of state. These articles must include the company name, the date of dissolution, and the method of authorization of dissolution. Next, the directors must notify the shareholders. If shareholders or creditors have claims against the corporation, they must make them known within a stipulated time frame. Although the corporation establishes the time frame, the period must extend at least 120 days after the date of dissolution. CASE OPENER WRAP-UP The Formation of the Facebook Corporation Zuckerberg's actions in 2004 were instrumental in creating what is now Facebook today. There are currently over 250 million users on the website from all over the world. In 2007, Microsoft bought a 1.6 percent share of the corporation for $240 million. Facebook gained another investor in November of that year, a billionaire from Hong Kong, Li Ka-shing, for $60 million. Estimates put the corporation's value around $4 billion to $5 billion. Ultimately, its corporate status allows Facebook to enjoy perpetual existence, to sue and be sued, to acquire property, to make contracts, to borrow and lend money, to make charitable donations, and to establish rules for managing the corporation. Moreover, Facebook's shareholders enjoy limited liability. PRACTICAL TIPS for Business Managers One of the biggest advantages to forming a corporation is the liability "veil" it provides. Due to a corporation's status as a "legal person," most legal disputes are aimed at the corporation and not at its shareholders. Remember, however, that this veil is not entirely impenetrable; shareholders can, on occasion, be held liable for corporate actions. In other words, do not assume that forming a corporation makes you legally bulletproof. Remember that most states will not allow you to do business in their state unless you file a certificate of authority in that state. Failure to do so can result in fines and other legal trouble. It may be wise to create a shareholder agreement that outlines the rights and responsibilities of shareholders. Such an agreement limits the power of shareholders and may prevent the increasingly popular trend of shareholder activism.

SUMMARY Characteristics of Corporations Legal entity. Rights as person and citizen. Creature of the state. Limited liability of shareholders. Unrestricted transferability of corporate shares. Perpetual existence. Centralized management. Corporate taxation. Liability for corporate agents. Corporate Powers Corporations have both express and implied powers. An ultra vires act is a corporate action that is beyond the scope of the corporation’s authority. Classification of Corporations Public or private. For profit or nonprofit. Domestic, foreign, or alien. Publicly held or closely held. S corporations. Professional corporations. Formation of the Corporation To create a corporation Promoters organize corporate formation. Subscribers offer to purchase stock in the corporation during the formation process. A state is selected for incorporation. Legal Process of Incorporation The legal requirements are Selecting the corporate name. Drafting and filing the articles of incorporation. Holding the first organizational meeting. Potential Problems with Formation of the Corporation Remedies for defective incorporation include De jure corporations. De facto corporations. Corporations by estoppel. Piercing the corporate veil. Corporate Financing Debt securities (bonds). Equity securities (preferred stock and common stock). Roles of Directors, Officers, and Shareholders Directors A minimum number must attend board of directors meetings. They are legally responsible for day-to-day managerial activities. Officers Run the day-to-day business of the organization. Act as agent of the corporation. Shareholders Approve major corporate decisions. Elect and remove members of the board of directors. Duties of Directors, Officers, and Shareholders Directors and officers Duty of care. Duty of loyalty. Duty to disclose conflicts of interest. Majority shareholder Duty of care and loyalty when selling shares. Liabilities of Directors, Officers, and Shareholders Directors and officers Personally liable for their own torts and crimes. Liable for torts and crimes of others when there was inadequate supervision. Shareholders Liable for debts of the corporation to the extent of their investment. Rights of Directors, Officers, and Shareholders Directors Compensation. Participation. Inspection. Indemnification. Officers’ rights are spelled out in their employment contract. Shareholders Right to vote at the shareholders’ meeting. Preemption. Inspection. Share transfer. Petition for dissolution. Direct and derivative suits against the corporation. Purchase of Stock An acquiring corporation can take control of another corporation by purchasing a substantial amount of its voting stock. The Nature of Takeovers A corporation can expand its size and operations by purchasing the stock of another firm. A hostile takeover is a

takeover to which the management of the target corporation objects. Types of takeovers Tender offers. Exchange offers. Cash tender offers. Response to Termination Response to takeovers: Directors declare whether they accept or reject the offer. If they object to the offer, they can engage in methods of resistance. Dissolution is the legal death of a corporation.

Point/Counterpoint Is Shareholder Activism Good for Business? Shareholder activism is a process in which a major shareholder or shareholders use their voting rights in the company to force the management to either change their practices or be ousted by the shareholders. Shareholders may take this approach due to their dissatisfaction with the corporation's environmental or social policies, or simply because they feel the management is poorly running the business. YES NO Over the last 30 years, shareholder activism has become an increasingly common practice as shareholders expect more from the corporations they invest in. While corporations are often fearful of shareholder activism gaining a foothold in the company, it can sometimes be just what the business needs. When the management board of a corporation gets complacent or ineffective, it can be very difficult to get them to budge and work hard enough to get the maximum value out of their stock. That is where shareholder activists come in. Shareholder activists can hold the management's feet to the fire and force them to shape up or face hostile takeover. Another benefit of shareholder activism is that the practice can quickly increase the value of a corporation's stock, at least in the short run. Shareholder activists tend to snatch up a large percentage of a corporation's stock in a short period of time to gain a significant foothold in the company. The mass buy up of stock will likely catch the attention of other investors, and the share price will rise. Not all shareholder activism focuses on maximizing share value, however. Some groups of shareholder activists seek to hold a corporation's management accountable for harmful environmental or social practices that go beyond what regulatory oversight can prevent. Shareholder activism forces the management to shape up or face being replaced and is therefore a great tool for making drastic change within a corporation. Shareholder activism has become a popular tool for shareholders to assert their influence over a corporation, but it often is not the right tool for the job when it comes to benefiting a corporation in the long run. First of all, shareholder activism often involves investors buying up enough of a corporation to try to control the management of that

corporation. But this method only works if the shareholders know how to run the business better than the management, which seems unlikely when you consider that it is the management that has the daily hands-on experience of actually running the company. Shareholders may think they know what it takes to improve the business, but shareholders are not always right, and they are arguably not in the best position to know what to do. A second problem with shareholder activism is that many people who engage in the practice are not “activists” at all, but are corporate raiders trying to take over a company through buying up a lot of stock. Often, these corporate raiders will purchase enough stock to have large-scale voting rights, compel a hostile takeover, sell off the company’s assets to boost the stock price, and then sell off all of their shares to make a quick profit. These two reasons highlight a final reason why shareholder activism is bad for business: the practice has only the short-term interests of a business in mind, not the long-term interests. The goal of almost all shareholder activists is to raise the value of the corporation’s stock to increase the value of their own assets. These shareholder activists have little concern, however, for the company’s well-being after they sell off their stock, and the decisions they influence in order to make short-term gains may not be what is best for the business in the long run.

Questions & Problems Name at least three characteristics that distinguish corporations from other forms of business organization. How is an ultra vires act related to a corporation’s powers? Compare and contrast common stock and preferred stock. Explain the primary duties of officers and directors. What is the business judgment rule? Carnival Corporation & PLC is a dual-listed corporation, i.e., a corporate structure that joins separate corporations in a common economic enterprise. The dual-listed corporation (DLC) was formed by Carnival Corporation, a corporation headquartered in Florida, and Carnival PLC, a British company headquartered in Southampton, England. Zolt Sabo, Ilija Janev, and Stefan Vidojkovic (The Seafarers) were workers aboard a cruise ship, working for Cunard Celtic Hotel Services, Ltd., a company that operated under the corporate umbrella of Carnival Corporation & PLC. The Seafarers sustained back injuries while working aboard the cruise ship and collected benefits in accordance with their employment contract. However, the Seafarers became unsatisfied with their compensation and believed that their contracts unfairly limited it. In July 2012, Sabo, Janev, and Vidojkovic filed a class action lawsuit against Carnival Corporation and Carnival PLC, alleging failure to provide maintenance and cure in accordance

with general US maritime law and the Jones Act, a federal statute that provides legal remedies not guaranteed under general maritime law. The defendants filed a motion to dismiss, asserting that the Seafarer's claims should be dismissed because the court lacked jurisdiction over Carnival PLC, and Carnival Corporation was shielded from liability due to its corporate form. In the Seafarer's final response, the plaintiffs made clear that they were only suing Carnival Corporation & PLC, the dual-listed corporation, and further asserted that the DLC was a suable entity because it was in reality a corporation, the Carnival Corporation & PLC was subject to corporation by estoppel, among other claims. For the first claim, the Seafarers argued that Carnival Corporation & PLC resembled a corporation in many ways and claimed that "Carnival Corporation & PLC operate[s] as a single enterprise sufficient to establish personal jurisdiction over both entities as a single operation." Is this enough to qualify Carnival Corporation & PLC as a corporation? What would the DLC need to have done to be considered as a corporation and thus suable by the plaintiffs? What are the requirements for corporation by estoppel? Does corporation by estoppel apply in this case? Source: Sabo v. Carnival Corp., 762 F. 3d 1330 (2014). The Chomiak family opened a seasonal summer resort on the shores of Lake George in 1957. To run the resort, the Chomiaks formed a closely held corporation called Twin Bay Village, Inc. One hundred shares were issued which were split between Stephan and Eleonara Chomiak and their two sons, Vladimir and Leon. Decades later in 2004, the shares passed hands and Vladimir's son and daughter were the beneficial owners of a total of 48 shares in Twin Bay Village. Leo and his two daughters owned the remaining 52 shares. Ownership of shares were not the only things that changed in Twin Bay Village. By this point, Vladimir no longer helped manage the corporation, and only Leo and his two daughters were still involved. In 2009, the majority shareholders, Leo and his two daughters, attempted to force the minority shareholders to sell their shares back to the corporation. Met with refusal, the majority shareholders filed a suit to force dissolution of the corporation. The minority shareholders subsequently countersued, alleging the majority shareholders had breached their fiduciary duty to them by engaging in oppressive behavior and looting corporate assets. The trial court ruled in favor of Vladimir and his two daughters, the minority shareholders, for all claims alleged by them. While Leo appealed the decision, the appellate court affirmed the trial court. Could the minority shareholders apply Section 14.30 of the RMBCA to initiate a dissolution based on the claims it won? In other words, is Section 14.30 applicable to the claims of this case? Why or why not? What kind of evidence did the appellate court look at to determine that

corporate looting took place? Source: Matter of Twin Bay Village, Inc., 153 AD 3d 998 (2017). Page 550Indiana Electronic Workers Pension Trust Fund (IBEW) is a retirement system that provides benefits to electrical workers in Indiana. IBEW is also a stockholder of Wal-Mart corporation. Wal-Mart de Mexico (WalMex) is a subsidiary of Wal-Mart, in which Wal-Mart owns a controlling interest. In April 2012, The New York Times released an article titled Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle, which described a scheme of illegal bribery payments to Mexican officials that occurred between 2002 and 2005, at the direction of the then-director of WalMex. The article showed that Wal-Mart officials knew of the illegal conduct no later than September 2005 and suggested that Wal-Mart's response was deficient. In June 2012, IBEW sent a letter to Wal-Mart requesting inspection of documents related to the WalMex incident so that the IBEW board could investigate if Wal-Mart had breached fiduciary duty and if a derivative suit was necessary. In August, Wal-Mart complied with IBEW's request, but most of the documents were highly redacted with no explanation for the redaction. IBEW subsequently filed a complaint with the court of chancery, alleging that certain documents within the scope of the demand had not been produced. After a series of court hearings, the court entered a final order in October 2013. In its final order, the court required Wal-Mart to produce documents protected by attorney-client privilege, as well as other privileged documents, among other kinds of documents. The court also granted the IBEW's use of whistleblower documents, which IBEW had anonymously received and promptly reported in May 2012. Both parties appealed to the Supreme Court of Delaware; Wal-Mart asserted that the court had ordered Wal-Mart to produce documents that far exceeded the scope of the request and IBEW cross-appealed in regards to the whistleblower documents, as well as other assertions. What is the Garner Doctrine as described by the Supreme Court of Delaware, and how is it related to this case? What arguments did Wal-Mart make to assert that IBEW had not met its burden to show it needed the privileged information that IBEW sought? What do you think of Wal-Mart's arguments? How did the Supreme Court of Delaware decide? Source: Wal-Mart Stores v. Indian Elec. Workers, 95 A.3d 1264 (2014). Moto Inc. operates gasoline convenience stores throughout the American Midwest. It does business as MotoMart. In June 2011, the collective owners of at least 20 percent of Moto, Virgil Kirchoff, Kirchoff LP, and the Virgil Kirchoff Revocable Trust, launched a suit against Moto seeking corporate dissolution based on minority shareholder oppression. The plaintiffs asserted that by arbitrarily valuing its stock and failing to inform minority shareholders of Casey's General Stores, Inc.'s

interest in acquiring Moto. The trial court granted Moto summary judgment and the plaintiffs appealed. According to the appellate court, to fulfill a shareholder oppression claim, a claimant must show “(1) burdensome, harsh, and wrongful conduct; (2) a lack of probity and fair dealing in the affairs of the company to the prejudice of some of its members; or (3) a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder is entitled to rely when entrusting her money to a company.” In its appeal, the plaintiffs-now-appellants argued the trial court should not have granted Moto summary judgment because Moto had a fiduciary duty to use reasonable care in evaluating its stocks and there was enough prima facie evidence showing Moto failed to exercise reasonable care. Suppose the appellate court accepted the appellants’ argument that there was a genuine dispute of material fact about Moto’s actions. Would Moto’s lack of reasonable care fulfill the three requirements of a shareholder oppression claim quoted above? Why or why not? List examples of evidence appellants could show to meet the criterion. Source: Virgil Kirchoff Revoc. Trust v. Moto, Inc., 482 SW 3d 834 (2016). Page 551Volcano Corporation was a San Diego based Delaware medical technology corporation that was a global leader in “vascular intervention and lead management solutions.” Beginning in January 2014, Volcano’s board of directors began exploring merger options as part of its general business development outreach. Volcano enlisted Goldman Sachs to evaluate other companies’ interest in such a transaction. To this end, Goldman Sachs procured a list of six “tier 1 buyers” and seven “tier 2 buyers.” Volcano reached out to five “tier 1 buyers” to gauge interest in a merger. However, all five companies declined. In June 2014, two months after the five contacted companies rejected Volcano’s merger proposal, the sixth company on the “tier 1 buyers” list, Philips Holdings, a fully owned subsidiary of a Dutch health technology company, expressed interest in acquiring Volcano through a merger. Following a series of confidential meetings, Philips delivered a nonbinding expression of interest to buy Volcano out at $24 per share subject to an eight-week period during which Philips would perform due diligence. Volcano’s common stock closed at $16.18 per share when Philips delivered its indication of interest. However, after an August press release where Volcano stated it was lowering its revenue guidance for the rest of the year, Volcano’s common stock price fell to $12.56 per share. Philips informed Volcano it was lowering its asking price from $24 per share to between $17 and $18 per share. The parties ceased working on the transaction in September 2014 after failing to find a common price point. Third time was the charm for Volcano and Philips as, after a second fizzling out of merger

negotiations, Volcano agreed to be bought out by Philips at $18 per share. The parties executed a two-step merger. In December 2014, Philips issued a tender offer to purchase all of Volcano’s common stock at $18 per share. When the tender offer closed in February 2015, 89.1 percent of Volcano’s shares were tendered. Philips then completed the merger without a shareholder vote. Before the merger concluded, three plaintiffs filed lawsuits, which were combined into a class action lawsuit, to enjoin the merger. The plaintiffs withdrew their motion in January 2015 but filed new complaints in March 2015, alleging Volcano’s board of directors breached its duties of care and loyalty in regard to the merger. The defendants filed a motion to dismiss, and the court determined that the business judgment rule would be used as the legal standard to evaluate the plaintiffs’ claim. Furthermore, the court ruled that the business judgment rule irrebuttable applied to the case. What is the business judgment rule and how does it generally protect directors and officers? What is the distinction between rebuttable and irrebuttable applications of the business judgment rule according to the court? Source: In re Volcano Corp. Stockholder Litigation, 143 A. 3d 727 (2016).